CLERK'S COPY.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1945

No. 263

E. L. LUSTGRAAF, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED JULY 28, 1945.

CERTIORARI GRANTED OCTOBER 8, 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 263

A. L. LUSTHAUS, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

INDEX

	Original	Print
Record from The Tax Court of the United States	1	1
Docket entries	1	1
Statement of evidence	3	2
Caption and appearances	3	2
Testimony of A. L. Lusthaus	4	3
Lillian Lusthaus	32	24
Ross C. Tenney	42	32
Joseph W. Ray, Jr.	50	37
F. W. Ries, Jr.	59	44
Exhibit No. 1—Article of Agreement	64	48
Exhibit No. 3—Partnership Return of Income, 1940	71	52
Exhibit No. 4—Bill of Sale	75	53
Exhibit No. 6—Promissory Note	79	56
Exhibit No. 9—Balance Sheet—Jan. 1, 1940	80	57
Exhibit No. 11—Balance Sheet—Dec. 31, 1940	82	58
Exhibit No. 15—Analysis of Investment Accounts	83	59
Exhibit No. 16—Analysis of Withdrawals	84	60
Findings of fact and opinion, Smith, J.	86	65
Decision	93	67
Proceedings in U. S. C. C. A., Third Circuit	94	67
Order assigning judge	94	67
Opinion, McLaughlin, J.	95	68
Dissenting opinion, Fake, J.	99	71
Judgment	110	79
Petition for rehearing	111	79
Order denying petition for rehearing	120	86
Clerk's certificate (omitted in printing)	121	
Order allowing certiorari	122	87

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., OCTOBER 24, 1945.

—900

[fol. 1]

IN THE TAX COURT OF THE UNITED STATES

Docket No. 112702

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DOCKET ENTRIES

1942

Oct. 10—Petition received and filed. Taxpayer notified. Fee paid.

Oct. 12—Copy of petition served on General Counsel.

Oct. 10—Request for Circuit hearing in Pittsburgh, Pennsylvania, filed by taxpayer. 10-12-42 Granted.

Nov. 18—Answer filed by General Counsel.

Nov. 21—Copy of answer served on taxpayer. Pittsburgh, Pa.

1943

July 27—Hearing set Sept. 20, 1943. Pittsburgh, Pa.

Aug. 13—Application for subpoena to A. L. Lusthaus and Lillian C. Lusthaus filed by General Counsel. Subpoenas (2) issued.

Aug. 13—Application for subpoena duces tecum to F. W. Ries, Jr., filed by General Counsel. 8-13-43 Subpoena issued.

Sept. 6—Application for subpoena duces tecum and subpoena issued to respondent for T. A. L'Estrange or proper person designate.

[fol. 2]

Sept. 22—Hearing had before Judge Smith on merits. Submitted. Appearance of Paul E. Hutchinson filed. Briefs due 11-1-43. Replies 11-24-43.

Oct. 4—Transcript of hearing 9-22-43 filed.

Oct. 22—Joint motion for extension of 30 days to file briefs filed. 10-23-43 Granted.

Nov. 30—Brief filed by taxpayer.

Dec. 1—Motion for extension to Dec. 15, 1943 to file brief filed by General Counsel. 12-2-43 Granted.

Dec. 15—Brief filed by General Counsel. Served 12-16-43.

Dec. 16—Copy of brief served on General Counsel.

1944

Jan. 10—Reply brief filed by taxpayer. 1-10-44 Copy served.

Mar. 29—Findings of fact and opinion rendered, Smith, Judge, Decision will be entered for respondent. Copies served.

Mar. 29—Decision entered, Smith, Judge, Div. 5.

Apr. 20—Order correcting report entered 3-29-44. Smith, Judge.

May 12—Petition for review by U. S. Circuit Court of Appeals, 3rd Circuit, filed by taxpayer, 5-12-44—1 additional copy received.

May 15—Notice of filing petition for review sent to J. P. Wenchel filed.

May 16—Proof of service filed.

May 30—Designation of contents of record filed by taxpayer and proof of service thereon.

[fol. 3]

Jun. 19—Motion for extension of time to August 10, 1944 to prepare, transmit and deliver the record filed by taxpayer.

Jun. 19—Order extending time to August 10, 1944 to prepare, transmit and deliver the record entered.

IN THE TAX COURT OF THE UNITED STATES

Statement of Evidence

Federal Courtroom, Pittsburgh, Pa.
Sept. 22, 1943—10:10 a. m.

(Met pursuant to notice.)

Before Hon. Charles P. Smith, Judge.

APPEARANCES:

A. G. Wallerstedt, C. P. A., W. A. Seifert, Esq., William Wallace Booth, Esq., Joseph W. Ray, Jr., Esq., Paul E. Hutchinson, Esq., 747 Union Trust Building, Pittsburgh, Pa., appearing for the Petitioner.

W. J. McFarland, Esq., 2304 Clark Building, Pittsburgh, Pa., appearing for the Respondent.

[fol. 4] PROCEEDINGS

* * * Omission from Transcript pages 4, 5 and 6.

A. L. LUSTHAUS, 170 Stockton Avenue, Uniontown, Pennsylvania, the Petitioner, called as a witness in his own behalf, first being duly sworn, testified as follows:

The Court: Please give your name and address to the stenographer.

Mr. Lusthaus: A. L. Lusthaus, 170 Stockton Avenue, Uniontown, Pennsylvania.

Direct examination.

By Mr. Wallerstedt:

Q. Mr. Lusthaus, are you the taxpayer petitioner in this case?

A. Yes.

Q. What is your business?

A. I conduct two furniture stores in Uniontown, partnership with Mrs. Lusthaus.

Q. How long have you been in the furniture business, Mr. Lusthaus?

A. Since 1918.

Q. Since 1918?

A. Yes.

Q. Will you sort of detail your operations?

A. In 1918 I bought an interest in a corporation; in 1921 I purchased the balance of the stock from the other stockholders; in 1926 I combined with Cohen Furniture Company in Uniontown up to 1933, where we divided up and I took over the Household Furniture Company and I went in as a sole owner until 1940. In January, 1940, I sold half to my wife, Mrs. Lusthaus.

[fol. 5] Q. Mr. Lusthaus, when did you decide to offer your wife an interest in the partnership?

A. I'm sorry. Will you please repeat that.

The Court: The stenographer will read back the last question.

(The last question was read to Mr. Lusthaus.)

The Witness: Sometime during 1939.

By Mr. Wallerstedt:

Q. Will you please tell us what happened in the fall of 1939 or in 1939?

A. In 1939 my wife and I decided—I asked my wife to come in and buy a half interest in the store and she agreed to do so.

Q. She accepted your offer?

A. She accepted my offer; yes, sir.

Q. That was in the fall of 1939?

A. Yes.

Q. And when was this partnership started?

A. It started January, 1940.

Q. At the beginning of January?

A. At the beginning of January, 1940.

Q. Now, did you discuss the matter at all with your lawyer?

A. I did. I discussed it with Mr. Ray.

Q. Is Mr. Ray here in the courtroom?

A. Yes, sir.

Q. And when did that discussion take place with your lawyer?

A. Several times in 1939.

Q. What was the selling price between you and your wife as to the one-half interest of the partnership?

A. The selling price would be $105,000.

Q. And how did you arrive at that amount?

[fol. 6] A. I gave my wife a check, an outright gift of $55,000, and the balance of $50,000 I took back notes payable, $5,000 a year.

Q. Do you recall whether or not you were to take out any money at first?

A. It came at first to $230,000 so we agreed at first I should draw out $20,000 to make it an equalized $210,000.

Q. And when did you draw out this $20,000, if you remember?

A. In January, 1940; I believe it was the first week in January.

Q. Now, what instructions, if any, did you give to your lawyer in the fall of 1939?

A. I gave the instructions to my lawyer to draw up a partnership agreement and the partnership was to take effect as of January 1, 1940.

Q. And that was Mr. Ray, the attorney that is here?

A. Mr. Ray. I asked him to draw up the necessary papers which were required for the partnership.

Q. What was his answer to that?

A. He agreed. Mr. Ray agreed that he would do that.

Q. Well, now, did he draw up those papers?

A. No. Mr. Ray took sick in the latter part of 1939 and in the early part of January 1940, but Mr. Ray sent word to me that we can start our partnership and as soon as he gets back to the office he would fix up our books as of January 1, 1940.

Q. What happened to you and your wife at that time?

A. My wife and I went to Florida during the early part of March and we came back at the end of the month and got [fol. 7] in touch with Mr. Ray and Mr. Ray informed me that the papers were ready and to go right ahead.

Q. Then did you sign some partnership agreements; other papers that he had for you?

A. I did.

Q. In 1939 when you were discussing this partnership with your wife, did you discuss anything about the terms of the partnership, how it would operate, etc.?

A. Mr. Ray and I talked it over several times and we come to the conclusion that we would give my wife $50,000 and the balance in notes.

Q. You say you were to give your wife the balance in notes?

A. My wife would give me the difference in the price of the store, the difference in notes, payable yearly.

Q. Now, generally, what were the terms of that agreement that you spoke to Mr. Ray about; how was it to function?

A. The agreement was to pay the $50,000 and the balance of $55,000 in $5,000 notes each.

The Court: Do I understand your testimony to be, Mr. Lusthaus, that your wife actually paid over to you $50,000?

The Witness: Yes, sir; she did. $50,000 and three hundred something to make it an equal amount.

By Mr. Wallerstedt:

Q. I show you a paper entitled Articles of Agreement, Mr. A. L. Lusthaus—Abraham Lusthaus and Lillian Lusthaus—and ask you what that is?

A. This is the agreement that was drawn between Mrs. Lusthaus and myself.

Q. And is that your signature appearing on page 7?

[fol. 8] A. Yes, sir; it is.

Q. And is that the signature of your wife?

A. Yes, sir.

Mr. Wallerstedt: I offer in evidence paper shown marked Articles of Agreement, a photostat copy, the attorney for the other side having agreed to submit a photostatic copy instead of original.

Mr. McFarland: No objection.

The Court: That will be received in evidence and marked Petitioner's Exhibit 1.

(Copy of Articles of Agreement received in evidence and marked Petitioner's Exhibit 1, of this date.)

* * * Omission from Transcript pages 11 and 12.

By Mr. Wallerstedt:

Q. I show you a paper and ask you what that is?

A. This is a partnership return of the Household Furniture Company for 1940.

Q. By the way, Mr. Lusthaus, this partnership, under what name does it operate?

A. Household Furniture Company.

Q. How many stores do you operate?

A. Two stores.

Q. And what are the names of those?

A. One store is in the Household Furniture Company and the other store goes under the name of the Furniture Outlet.

Q. Both stores are operated under the partnership?

A. Both stores operate in one partnership.

Mr. Wallerstedt: I offer in evidence the partnership return for 1940.

Mr. McFarland: No objection.

[fol. 9] The Court: That will be marked Petitioner's Exhibit 3 and received.

(The partnership return for 1940 was received in evidence and marked Petitioner's Exhibit 3, of this date.)

By Mr. Wallerstedt:

Q. Mr. Lusthaus, since January 1, 1940, with the exception of this $20,000 that you drew out of the business, have you drawn out any cash or other property from the partnership?

A. Yes, sir.

Q. Has your wife drawn out any money?

A. Yes.

Q. Can you tell us just how you withdrew moneys, you and your wife?

A. My wife and I drawing a salary of $100 a week. I draw fifty and my wife draws fifty every week and from year to year at the end of the year, we have drawn out money whenever we need it from time to time.

Q. And in what proportions do you draw the money out?

A. It all depends. We draw sometimes large amounts or small amounts.

Q. Supposing that you draw out—if you draw out $10,000, how much would your wife draw out?

A. We divide equally, half. I take half and half goes to my wife.

Q. You get half and your wife gets half?

A. Half goes to me and half to my wife's account.

Q. Who kept the books of this partnership?

A. We have bookkeepers in the store keep the books.

Q. Do you have any public accountants?

A. Mr. Ross C. Tenney, public accountants.

[fol. 10] Q. Who are Tenney and Company?

A. They are public accountants in Uniontown. They have their offices there.

Q. Now, at the time you instructed your attorney to draw up these legal papers in the fall of 1939, what, if any, instructions did you give to Mr. Tenney?

A. I gave instructions to Mr. Tenney to close up the partnership—to close up my own as an individual and open up the partnership books.

Q. As of what date?

A. As of January 1, 1940.

Q. And did Mr. Tenney do that?

A. Mr. Tenney used the same books but he set up a partnership in the same books.

Q. He used the same books?

A. The same books, but he started as a partnership as of January 1, 1940.

Q. In other words, you made some adjustments to convert the books into a partnership?

A. Yes, sir.

Q. Can you tell me when Mr. Tenney was in your office working on these books making the necessary entries to convert the individual books into a partnership set of books?

A. I don't know exactly. I believe it was in January, 1940.

Q. Mr. Tenney was in the courtroom, was he not?

A. Yes, sir; he was.

Q. He was excluded?

A. Yes, sir.

Q. I show you a paper and ask you what that is, Mr. Lusthaus?

A. This is the bill of sale that I have taken and sold a half interest to Mrs. Lusthaus.

[fol. 11] Q. And whose signatures appear on that paper?

A. My signature first and Mrs. Lusthaus's underneath.

Q. And they are properly witnessed?

A. Yes.

Q. There is an Exhibit A attached to said paper, marked Balance Sheet, December 31, 1939?

A. Yes.

Q. Can you tell me who prepared that statement?

A. Tenney and Company, auditors.

Mr. Wallerstedt: I offer in evidence a photostat copy of the bill of sale.

Mr. McFarland: No objection.

The Court: It will be received and marked Petitioner's Exhibit 4.

(Photostat copy of the bill of sale was received in evidence and marked Petitioner's Exhibit 4, of this date.)

By Mr. Wallerstedt:

Q. I show you a check on the Second National Bank of Uniontown, drawn to your order in the amount of $50,253.81, signed by Lillian Lusthaus; is that her signature?

A. Yes, sir; this is Mrs. Lusthaus's signature.

Q. Did you receive that check?

A. I did.

Q. And what was it given to you for?

A. That was given in part payment of the interest that I sold to Mrs. Lusthaus.

* * * Omission from Transcript pages 16 and 17.

By Mr. Wallerstedt:

Q. I show you a set of papers clipped together consisting of 11 sheets and ask you what they are?

A. These are 11 notes at $5,000 apiece to be paid on the [fol. 12] first of each year until they are paid, given to me by Mrs. Lusthaus.

Q. For what purpose?

A. To pay for part of the rest of her interest in—that she bought in the Household Furniture Company.

Mr. Wallerstedt: I offer in evidence a photostatic copy of this group of notes.

Mr. McFarland: No objection.

The Court: That will be marked Petitioner's Exhibit 6 and received in evidence.

(Photostatic copy of 11 sheets of paper (notes) were received in evidence and marked Petitioner's Exhibit 6, of this date.)

By Mr. Wallerstedt:

Q. Have any of these notes been paid?

A. Three notes have been paid, one in January 1, 1941, and '42 and '43.

Q. And those notes are marked paid on this——

A. Yes.

Q. Has the interest on these notes been paid?

A. Yes, sir.

Q. Do you recall whether you included the interest that you received from these notes in your tax returns?

A. I did.

Q. Does the partnership have a bank account?

A. It has.

Q. In what name is that partnership?

A. Household Furniture Company.

Q. Did you have a personal bank account?

A. I have.

Q. Does your wife have a personal bank account?

A. Yes, sir.

[fol. 13] Q. Mr. Lusthaus, have you at all times since January 1, 1940 held yourself out to the public as a partnership?

A. I did.

Mr. Wallerstedt: You may cross-examine.

Cross-examination.

By Mr. McFarland:

Q. Mr. Lusthaus, when is the first time you met with F. W. Ries, Jr., of this city?

A. Off and on for several times. I don't remember exactly what would be the first time.

Q. When would you say, within what year or what part of the year?

A. Well, you could date it as far back as the late 1920's because Mr. Ries called on us at various times at the Cohen Furniture Company—I can't recollect how far back.

Mr. Wallerstedt: I don't believe this is proper cross-examination because it's not material and is therefore not proper cross-examination.

The Court: Let me rule on that.

Mr. McFarland, was there anything in direct examination that warranted those questions?

Mr. McFarland: The only thing I am trying to ascertain, if the Court please, I understand that Mr. Ries and Mr. Tenney—in addition, I am not certain—Mr. Lusthaus—I don't know who else—met in Uniontown around in September of 1939. That there were certain conclusions reached about the formation of a partnership involving Mrs. Lusthaus at that meeting and I'm just seeking to ascertain just what occurred in as much as the question of whether or not a partnership existed in the case is an [fol. 14] issue. I think that all these facts and circumstances surrounding the whole series of transactions should be probed, and I think that I have a right to examine them along these lines.

The Court: You may continue. I'm not sure whether it is correct cross-examination, but it's not very material whether it's brought out in cross-examination or whether the witness is called by the Government's own counsel in

as much as the Government counsel has now explained what he is driving at. I think it's probably all right.

Mr. McFarland: I may say at this time that I have subpoenaed Mr. Ries.

The Court: You have a right to call him on direct examination to bring out these questions. It's just a question of whether it is correct cross-examination. It's highly technical.

By Mr. McFarland:

Q. Directing your attention, Mr. Lusthaus, to September 1, 1939, I believe you had a conference with Mr. Ries and Mr. Tenney, did you not, at Uniontown?

A. Yes, I believe I did.

Q. What was discussed at that conference?

A. I believe it was discussed the partnership, to sell a half interest to Mrs. Lusthaus.

Q. Mrs. Lusthaus wasn't present at the time, was she?

A. I really don't remember; I don't know; possibly she was.

Q. Would you say she was or wasn't?

A. I'd say she wasn't.

Q. What was the reason for the discussion of whether or not you would form a partnership with Mrs. Lusthaus at this time?

[fol. 15] Mr. Wallerstedt: I object to that, your Honor.

The Court: Objection is overruled.

Mr. Hutchinson: If the Court please, this should be brought out by the Government's own witness and is not proper cross-examination. The reason for this agreement is not material to this issue.

The Court: Read back the last question.

(The last question was read back by the stenographer.)

The Witness: I didn't quite get it. What did you try what?

By Mr. McFarland:

Q. I just wanted to know the reason why you determined at this time, you and Mrs. Lusthaus, to form a partnership?

A. We were together most of the time and I decided to sell half an interest to Mrs. Lusthaus since Mrs. Lusthaus

has been with me in the store all the time working together, I decided to sell her a half interest and to make her half a partner in the store.

Q. Does Mrs. Lusthaus work with you in the store?

A. Very often.

Q. What does she do in the store?

A. Selling on the floor.

Q. She sells on the floor, does she?

A. At times she sells in the store whenever we are busy and need her she is in the store.

Q. You maintain a home in Uniontown?

A. I do.

Q. You have children?

A. I have.

Q. Does Mrs. Lusthaus take care of your home, too?

[fol. 16] A. I have a maid taking care of the home.

Q. Did you pay Mrs. Lusthaus a salary prior to the formation of this partnership when she worked for you?

A. Not before; we didn't.

Q. Her services were merely gratuitous; is that right?

A. Yes, sir.

Q. And in September 21, 1939 you decided to form a partnership?

A. I don't remember the exact date, but it was some time during 1939.

Q. At that conference that you held with Mr. Tenney and Mr. Ries, wasn't it determined that you should make a gift of $50,000 to Mrs. Lusthaus, and with that she should pay her part of her purchase price of the partnership?

Mr. Wallerstedt: I object to that. Where she got the money with which to pay for this partnership is immaterial.

The Court: Objections overruled.

The Witness: What was the question?

By Mr. McFarland:

Q. Were you not, as a result of the conclusions reached in that conference in Uniontown on September 21, 1939—did you not determine that you were to make a gift to Mrs. Lusthaus of $50,000 and with that and part of her own money to be added, she was to buy a half interest in the partnership? I should add, that in addition, issue certain

notes that were to be given to you to make up the full purchase price?

A. I don't remember how exactly we took that up at that time, but I had several discussions with Mr. Ray in [fol. 17] reference to the amount I should give Mrs. Lusthaus to buy a half interest in the store.

Q. You just gave it to her to buy the half interest? She was going to turn around and give you the money back?

A. Exactly.

Q. Did you file a gift tax return in 1940?

A. I did.

Q. And on that gift return, when did you state that you made the gift of $50,000 to Mrs. Lusthaus?

A. When?

Q. The date of the gift?

A. I don't remember.

Mr. Wallerstedt: I suggest you show him the return.

Mr. McFarland: I'll be very glad to.

By Mr. McFarland:

Q. (Showing paper to the witness) Is that your signature?

A. Yes, sir.

Q. And this is the gift tax filed by you for 1940?

A. Yes, sir.

* * * Omission from Transcript page 24.

By Mr. McFarland:

Q. When did you actually turn the money over to Mrs. Lusthaus pursuant to that agreement?

A. In June, 1940.

Q. By check?

A. By check.

Q. Would it be June 7, 1940?

A. The early part of June. I don't remember the date but it would be the early part of June.

Q. And on the same day when you paid Mrs. Lusthaus $50,000 in pursuance of your stated declaration to make a [fol. 18] gift to her in that amount, which, you said, gift was to be made on January 1, 1940, did you borrow any money from the Second National Bank of Uniontown?

A. I did.

Q. How much did you borrow from them on that day?

A. $20,000.

Q. Did you take that money in addition to the money that you withdrew from the partnership, and does that make up the gift that you gave her on June 7?

A. Yes, sir.

Q. That is, you didn't add any other money that you had from any other sources at that time, did you?

A. No, whatever money I had in my bank.

Q. I believe you testified that on June 18 you received by check from Mrs. Lusthaus the sum of $50,000—rather, $50,253.81?

A. Correct.

Q. And part of the purchase price under the terms of the bill of sale of the partnership?

A. Yes, sir.

Q. And did you pay off to the bank on the same date the amount of money that you borrowed on June 7?

A. I don't remember the exact date but I paid off the bank.

Q. You'd say it was paid off at about that time?

A. I presume it was about that time.

Q. When you borrowed the money from the Second National Bank, Mr. Lusthaus, on June 7, did you deposit it to your account?

A. I did.

Q. Did you discuss with Mrs. Lusthaus any of the conclusions reached at the meeting of September 21, 1939?

[fol. 19] A. I must have; I believe I did.

Q. Of course, in order to discuss the conclusions you'd have to first have had the meeting?

A. I have talked with Mrs. Lusthaus on several occasions during 1939 to make her a partner in the business.

Q. Did you ever arrive at any definite terms under which she would become a partner prior to that meeting?

A. I don't know. Mr. Ray and I have discussed it several times.

Q. What did you discuss with Mrs. Lusthaus?

A. That I would give her an outright gift of $50,000.

Q. You'd just make a gift to her of $50,000 and she would use that as the purchase price?

A. Yes, sir.

Q. How did you determine the purchase price of the partnership?

A. Through the books.

Q. Did you include the element of goodwill in that purchase price?

A. The what?

Q. What did you include in the purchase price?

A. The value of the business—of both stores.

Q. And how did you determine the value of the business?

A. Through the book value.

Q. And what did the book value take into consideration?

A. Merchandise, book accounts and other assets that we have in the store.

Q. By other assets you mean physical assets?

A. Physical assets.

[fol. 20] Q. When did your wife agree to buy in this partnership?

A. During the fall of 1939.

Q. What date?

A. I really don't know the date. It would be very hard for me to remember the date. We discussed it several times.

Q. As I understand it, you discussed it with your wife several times, but you never arrived at any definite conclusions or any conditions upon which the sale would be consummated; is that correct?

A. Well, we decided as of January 1, 1940.

Q. When did you decide as of January 1, 1940?

A. Some time in the later part of 1939.

Q. Did you have a written agreement at that time?

A. No, sir.

Q. Purely oral arrangement?

A. What?

Q. Purely oral arrangement?

A. Oral arrangement in Mr. Ray's office.

Q. And what were the terms of that oral agreement?

A. Just as I stated, that she would pay me $50,000 in cash and the balance to be paid in notes.

Q. Payable yearly?

A. Payable yearly in notes.

Q. In the amount of $5,000 each for 11 years?

A. Yes.

Q. Where was she to get the amount to be paid off yearly?

A. From the profits of the business.

Q. Did your wife, if you know, did your wife have any other available assets with which to purchase the business [fol. 21] other than what you were going—the amount you were going to give her?

A. No, she didn't have enough; she had some.

Q. How much did she have that actually went into the purchase price of the business?

A. That I can't tell you. I don't remember.

Q. Would it be $253.81?

A. I believe so.

Q. In other words, she added that to the $50,000 that you gave her to make up part of the purchase price?

A. To make up part of the purchase price.

Q. I believe you stated on direct examination that you and your wife were to draw equal portions from the business each year; is that correct.

A. After we became partners.

Q. And you state that you became partners on January 1, 1940?

A. As of January 1, 1940.

Q. If you know, how much did your wife withdraw from the partnership in 1940?

A. I really don't know.

Q. Would it be $59.61?

Mr. Wallerstedt: We expect to produce the books and the records showing all that.

Mr. McFarland: If he knows I think he is entitled to answer.

The Court: Yes, that's right.

Mr. Wallerstedt: If you remember.

The Witness: I don't remember how much she draws. We draw $100 weekly between the two of us.

By Mr. McFarland:

Q. And the records would show how much she withdrew?

[fol. 22] A. Yes, the records would show that.

Q. And the records of her withdrawals would be—where would I find them?

A. In the books of the Household Furniture Company.

Q. Under what category would they be kept?

A. I really don't know. My auditors would be very glad to show it to you?

Q. It probably would be under withdrawals of your wife?

A. There is a regular setup of our drawings. The bookkeeper takes care of that. I don't know.

Q. When did you notify your—Do you have a line of credit with any nationally known institutions?

A. I have.

Q. What are some of them?

A. Dun and Bradstreet——

Q. When did you notify—Will you finish your answer. I interrupted you.

A. Dun and Bradstreet.

Q. When did you notify Dun and Bradstreet that the partnership was in existence?

A. I really don't remember. I believe either during the year after June or the following January.

Q. Of 19——

A. 1941.

Q. Either June of 1940 or January?

A. Either during 1940 or 1941.

Q. Mr. Lusthaus, I will ask you if you will examine each of these four papers that are clamped together and ask if your signature appears on those papers?

A. Yes, sir, my signature appears right here (indicating). [fol. 23] Q. Does it appear on each of the four clamped documents?

A. It does.

Q. What are those documents?

A. These are employment tax returns.

Q. Filed by you?

A. Filed by me.

Q. For the year 1939?

A. Year 1939; yes, sir.

Q. I will ask you to examine the returns for the year 1940 and ask if your signature appears thereon?

—. Yes, sir.

Q. I likewise ask you to examine the returns filed for the year 1941 and as- the same question of you: Does your name appear thereon?

A. Yes, sir.

Q. In all of these it has been notarized, haven't they, in accordance with the provisions of the act?

A. Yes, sir.

Mr. McFarland: I'd like to introduce into evidence as Respondent's Exhibit B, C, and D, the social security or the employment tax returns filed by the Household Furniture Company for the years 1939, 1940 and 1941.

I may state that the amounts or figures thereon are in no way material to this case.

Mr. Wallerstedt: May I ask a few question on these?

Mr. McFarland: Surely.

By Mr. Wallerstedt:

Q. Mr. Lusthaus, who makes out these returns for you?

A. My bookkeeper, Miss Rose Christy.

[fol. 24] Q. And you know that they cover the employer's tax return?

A. They do.

Q. And that you sign them as she makes them out?

A. As she makes them out, I sign them.

* * * Omission from Transcript page 33.

The Court: Mr. Lusthaus, you had a bank account, I assume, prior to 1940?

The Witness: What's that?

The Court: You had a bank account prior to 1940?

The Witness: I have; yes, sir.

The Court: Did your wife have a bank account also?

The Witness: Before 1940 my wife and I had a joint account.

The Court: Joint Account?

The Witness: Joint Account.

The Court: Was there any change made in that joint account beginning with 1940 or in 1940?

The Witness: Yes, sir; Mrs. Lusthaus opened a separate account and so did I?

The Court: And in what account were the partnership funds deposited?

The Witness: Under the name of Household Furniture Company.

The Court: And who had a right to draw checks upon that partnership account?

The Witness: We both signed checks on the partnership account.

The Court: Was that by some agreement?

The Witness: Yes, sir.

[fol. 25] The Court: When was that arrangement with the bank made?

The Witness: That was made sometime this year. Mrs. Lusthaus could have signed checks any time.

The Court: How could she have signed them without authority of the bank?

The Witness: She had her signature here. It was there in the Household Furniture Company.

The Court: But you say that it wasn't until this present year that you gave the bank the right to accept her as a partner and the right to draw checks upon the partnership account.

The Witness: Yes, sir.

By Mr. McFarland:

Q. Mr. Lusthaus, Mrs. Lusthaus was not brought into your partnership until June 7, 1940; is that correct?

A. Correct.

Q. So she didn't have any authority to sign checks on behalf of the partnership of which she wasn't a member as of that date?

A. She didn't have at that time.

Q. The accounts were kept in one bank?

A. One bank.

Q. What bank was that?

A. Second National Bank, Uniontown.

Q. You signed these returns, did you not as owner through the years 1939 and 1940, Mr. Lusthaus?

A. Well, I signed my name. I believe the girl fills it out. I don't know exactly if it is "owner" or "partners." I usually sign my name.

Q. Well, if I showed you these you probably could determine——

[fol. 26] Mr. Wallerstedt: I think those documents speak for themselves.

Mr. McFarland: I notice that some of them are typewritten—some parts of them—and I'd like to examine him on that.

By Mr. McFarland:

Q. I direct your attention to the word "owner" appearing on the return for the quarter end of March 1, 1939 and ask you if that is your handwriting (indicating)?

A. (No response.)

Q. Does your handwriting appear under the same title for the return ending June 30, 1939?

A. This is not my writing.

Q. You examined it, of course, before you signed it?

A. I wouldn't say as a fact.

Q. And if it wasn't correct you'd correct it before you signed the return?

A. Not always. Miss Christy has full charge to do that work.

Q. You didn't look at that, you just signed it?

A. I usually signed it.

Q. And if she put your name down as partner or owner or president you wouldn't change or alter it one way or the other?

A. I don't think I would. I don't know. I probably would if I had seen it.

Q. Directing your attention to that part of the exhibit which is the return for the quarter ending June 30, 1941, how did you sign your name; in what capacity did you sign your name on that return (indicating)?

A. A. L. Lusthaus; I believe I signed "owner or owners." It's not a corporation.

[fol. 27] Q. How does it appear thereon?

A. "Partner" I believe (indicating).

Q. In what capacity did you sign the return for the quarter ending March 31, 1941?

A. Owner.

Q. Can you tell me from those returns, the latter two quarters of the year, in what capacity you signed?

A. Well, it would have to be signed, I believe, as owner.

Q. You examined the return, Mr. Lusthaus, you can determine from those?

A. You want to know what?

Q. I want to know in what capacity you signed the return for the quarter ended Sept.—what date does that bear—September 30, 1941 and for the quarter ended December 31, 1941?

A. September 30, 1941, "partner."

Q. December 31, 1941?

A. "Partner."

Q. The first time your name appears as a partner, Mr. Lusthaus, is in the return for the quarter end of June, the quarter end of June 30, 1941?

A. I believe so. The reason we don't use "partner" is because any time we place an order it's always placed under the name of Household Furniture Company. Our names very seldom appear, my name or Mrs. Lusthaus's name, unless it appears on checks, but we have no occasion of using our names.

Q. Except for the occasions that require you to sign in your official capacity as to these returns?

A. Yes, sir.

Mr. McFarland: I believe that's all.

[fol. 28] Redirect examination.

By Mr. Wallerstedt:

Q. I believe, you stated that your bookkeeper or your secretary, somebody in your office, makes these returns out. Is that a formality?

A. It's a formality.

Q. She just makes them out; the amounts involved are not large and you sign them?

A. I do.

Q. It's true that you operated as an individual up to 1940 and at that time you had to show under the name that is shown as "owner, president, partner, etc." and that prior to the partnership you marked them "owner?"

A. Yes.

Q. That is, it was generally typewritten on?

A. Yes, sir.

Q. And when it came to the succeeding years the girl just followed the old form, being a tax return, followed the old form and you signed them?

A. Yes, sir.

Mr. McFarland: The returns are present and it shows in what manner they were signed.

The Court: But I think that is proper redirect examination.

By Mr. Wallerstedt:

Q. Mr. Lusthaus, speaking of this checking account of the partnership, do you recall why it was, or was there any reason why you didn't open up a bank account as a partner with the authority of both of you to sign checks in the very beginning rather than this year?

A. There was no special——

[fol. 29] Mr. McFarland: May I object to that question, your Honor. I believe it's not a question of what he intended to do or why he didn't do something, but rather what he actually did do that is material to the case. I don't think that it is competent in that respect.

The Court: Objection overruled.

The stenographer will read back the last question to the witness.

(The last question was read back to the witness.)

The Witness: Your Honor, all bills that come in I check up. My contract with my wife is that I have full charge of the business, to run it, the business, as I did before, and therefore it wasn't really necessary for Mrs. Lusthaus to have any signature. It didn't matter if she did or did not because every bill paid I checked up—every bill with reference of a discount that we get, and therefore everything that is there I do.

By Mr. Wallerstedt:

Q. Would you say that was an oversight?

A. I would, yes, because I do just—I could just as well have her signature there because there was no reason why her signature should be there.

Q. What brought it you your attention this year, if you recall?

A. I have just thought of this year to open an account. I don't remember.

Q. Not to open the account?

A. To authorize her signature on that account.

Q. Is it your practice for you to sign checks in the office or does your wife sign checks for business affairs?

[fol. 30] A. I sign checks.

Q. So far as the bank account itself is concerned, it is part of the assets of the partnership, is it not?

A. Yes, sir; it is.

Q. And there Mrs. Lusthaus, from the start of the partnership, did own one-half of that cash account?

A. Oh, yes.

Mr. McFarland: I object, if the Court please. I believe Mr. Wallerstedt is testifying now rather than the witness.

The Court: That objection is sustained.
Mr. Wallerstedt: That's all from this witness.

Recross-examination.

By Mr. McFarland:

Q. You paid the bills and conducted all the commercial end of the business when you were the sole proprietor, didn't you?
A. I did.
Q. You do the same now, isn't that correct?
A. Well, checking the bills and everything.
Q. You hire and fire the employees, don't you?
A. We both do.
Q. You file the social security returns, don't you?
A. Yes, sir; the office does the filing.
Q. You pay by check the various bills that are rendered to you as the partnership; isn't that correct?
A. Yes, sir.

Mr. McFarland: That's all.
The Witness: The bookkeeper does the work.

By Mr. McFarland:

Q. You sign them?
A. Mrs. Lusthaus doesn't sign them.
Q. If she just happens to be there at that time?
[fol. 31] A. I am there every day.
Q. You conduct the business?
A. I do.
Q. I think, under the terms of the partnership, you do most of the business, don't you? You determine the policy of the business?
A. We discuss it with Mrs. Lusthaus when anything special comes up. We discuss it as we did before.
Q. You discussed it with her before, before the partnership came up, when you were going to buy a new building, or make a drastic change in your policy, you discussed that with her, didn't you?
A. We never had any occasion of buying a building.
Q. I'm just using that as an example. Maybe it didn't exist.
A. I believe we would.

Mr. McFarland: I believe that's all.

Mr. Wallerstedt: I'm not going into this very much because it's specifically set forth in the partnership agreement what his duties are as manager of the business.

That's all, Mr. Lusthaus.

(Witness excused.)

[fol. 32] Lillian Lusthaus, called as a witness in behalf of the Petitioner, being duly sworn, testified as follows:

The Court: Give your name and address to the stenographer.

The Witness: Lillian Lusthaus, 170 Stockton Avenue, Uniontown, Pennsylvania.

Direct examination.

By Mr. Wallerstedt:

Q. Are you the wife of Mr. A. L. Lusthaus, the taxpayer petitioner in this case?

A. Yes.

Q. And your name is Mrs. Lillian Lusthaus?

A. Yes.

Q. When were you married, Mrs. Lusthaus?

A. 1915.

Q. Your husband has testified here that he has been in the furniture business in Uniontown since 1918. Did you help him in this business to any extent, and if so, what did you do?

Mr. McFarland: I object to the form of the question, if the Court please. I believe that is leading the witness. I would just like to have Mr. Wallerstedt ask her what she did.

The Court: Will the stenographer read back the last question.

(The last question was read back by the stenographer.)

The Court: The objection is overruled. She may answer the question.

The Witness: I worked with him in the business. You mean, what did I do in the store?

[fol. 33] By Mr. Wallerstedt:

Q. Yes.

A. Waited on trade; made cash receipts; took cash, and helped in any way in any part of the store that I was needed in.

(Off-the-record discussion.)

By Mr. Wallerstedt:

Q. Will you explain what you did in your husband's store up to 1940, January 1, 1940?

A. I came to the store pretty regularly and sold to the trade, made cash, made receipts, and helped in any way that was necessary for me to do.

Q. Did you get any salary from your husband prior to January 1, 1940?

A. No.

Q. Why did you not get any compensation?

A. Well, I felt that anything that he had was mine and if I need money I always came to him for it and he gave it to me. He never refused me anything.

Q. Did you discuss anything with your husband in 1939 with your husband about his business affairs?

A. Yes.

Q. Can you tell me what your discussions were in general terms?

A. Well, he talked to me about my becoming a partner in the business and suggested that I buy a half interest in the business.

Q. And what was your thought on the subject?

A. I thought it was a very fine idea.

Q. And about what time was that; if you recall?

A. It was in the fall.

Q. In the Fall?

A. Of 1939.

[fol. 34] Q. Do you recall as to when the partnership was to go into effect; right away or when?

A. It was to become effective January 1, in 1940.

Q. That was entirely agreeable to you, was it?

A. Oh, yes.

Q. Do you recall the terms of this, how you were going to enter into this partnership agreement?

A. Well, he said that he had a plan where he could make me a gift, give me $50,000, and I would pay that as part of

the partnership, and the balance in notes, in equal notes, over a period of years.

Q. And what did you say to that?

A. I thought that was a very good idea.

Q. Did you have any property of your own on January 1, 1940?

A. Yes.

Q. Do you know what that consisted of, those properties; do you recall?

A. I had my home and I had some stocks.

Q. What type of home? What would be the approximate value of that home?

A. About 25 or $30,000.

Q. Do you recall the approximate value of any securities that you owned at that time?

A. I'd say 20,000, $25,000; something like that.

Q. I show you a paper that is marked petitioner's Exhibit 1, being the Articles of Agreement of partnership and ask you if that is your signature (indicating)?

A. It is.

Q. You have your own bank account?

A. I do.

Q. Do you recall when your own bank account was opened?

A. When it was opened?

[fol. 35] Q. When, approximately?

A. My personal bank account?

Q. Yes.

A. Oh, I don't recall; a good many years ago.

Q. This account is entirely separate, is it, from the partnership account?

A. Entirely separate.

Q. In what name does your individual account stand?

A. Lillian Lusthaus; my name.

Q. Does the partnership have a bank account?

A. Yes.

Q. Do you know what name it's under?

A. Household Furniture Company.

Q. Have you received any moneys from this partnership since January 1, 1940?

A. The partnership—yes.

Q. Under what circumstances do you get money from the partnership?

A. Well I draw $50 a week and then at intervals, when there are profits accrued, get divide those profits and I am credited with half and my partner is credited with half.

Q. And that is on the accounts of the partnership books?

A. On the partnership books.

Q. Do you actually get any cash out of the business?

A. Yes.

Q. What do you do with that cash?

A. Use it for whatever I need.

Q. Do you deposit it to your own personal account?

A. Always.

Q. Since January 1, 1940, have you reported your share [fol. 36] of this partnership income to the Federal Government?

A. Yes.

Q. Mrs. Lusthaus, I show you a paper and ask you if you will tell me what that is?

A. My tax return.

Q. For what year?

A. 1940.

Q. Is that your signature—I think the signature is on the other side (indicating)?

A. Yes, there it is (indicating).

* * * Omission from Transcript pages 48 and 49.

By Mr. Wallerstedt:

Q. I show you a paper marked Petitioner's Exhibit 5 and ask you if you know what that is?

A. That is the check I gave to Mr. Lusthaus in part payment of the partnership arrangement.

Q. I show you a pack of papers and ask you if you recognize those papers. These papers are marked Petitioner's Exhibit No. 6.

A. Yes.

Q. These are the notes?

A. My notes for a period of years; 11 notes.

Q. Is that your signature on all those papers?

A. Yes.

Q. Have any of these notes been paid?

A. Yes.

Q. Do you recall which ones?

A. Yes; 1940, '41—'41, '42, '43; three notes.

Q. I show you a paper marked Petitioner's Exhibit No. 4 and ask you if that is your signature appearing on page 3 (indicating)?

A. Yes.

Q. These papers which I have just shown you being the [fol. 37] bill of sale and the notes and the partnership agreement, who prepared those papers?

A. My attorney.

Q. And who is your attorney?

A. Joseph Ray.

Q. Who prepared your tax return for you?

A. Mr. Tenney; Tenney and Company.

Q. He is a public accountant?

A. Public accountant; Uniontown.

Mr. Wallerstedt: Cross-examination.

Cross-examination.

By Mr. McFarland:

Q. Mr. Ray is also your husband's attorney, Mrs. Lusthaus?

A. He is.

Q. Referring to the terms of the sale of the partnership interest by your husband to you, you didn't have any money to buy into the partnership in July 7, 1940?

A. I didn't have enough money for it at all. I had enough money for a part interest after I got the gift from him.

Q. You just took the gift and gave it right back to him?

A. On the advice of counsel I did what he told me to do.

Q. Did you or didn't you do that?

A. Yes.

Q. And the agreement that you had with your husband was that he would give you the $50,000 which you would use to buy into the partnership; isn't that right?

A. Yes.

[fol. 38] Q. And you also executed these 11 notes?

A. Yes.

Q. They are payable in what fashion?

A. $5,000 a year for 11 years.

Q. How much do you withdraw from the partnership weekly?

A. $50.

Q. And how much do you believe you withdraw from the partnership in the year 1940?

A. The year when?

Mr. Wallerstedt: Your Honor, the records will show——

By Mr. McFarland:

Q. The year 1904?

A. How much? I wouldn't remember exactly how much I withdrew.

Q. Would you approximate that for us?

A. 1940?

Q. Would it be $1,000 or $50,000?

Mr. Wallerstedt: I don't see the use in guessing. We'll have the actual papers here.

The Witness: I don't know. I couldn't tell you exactly.

By Mr. McFarland:

Q. Have you ever met Mr. Ries?

A. I have seen him.

Q. You never met him, have you?

A. I think I was introduced to him once.

Q. Did you attend a conference in Uniontown on September 21, 1939 in which Mr. Ries was present?

A. No; no.

Q. Did you discuss the conclusions reached between your husband and Mr. Ries and Mr. Tenney at that conference?

[fol. 39] A. No, I don't remember any conference with Mr. Ries.

Q. When is the first time that you knew of the terms of this partnership agreement that you subsequently signed?

A. When Mr. Lusthaus broached the subject to me.

Q. When was that?

A. In 1939; in the fall.

Q. In the fall of '39?

A. Yes.

Q. And this is the partnership agreement that you actually reduced to writing in June 7, 1940; is that correct?

A. Yes.

Q. You hadn't bought into the partnership on January 1, 1940?

A. We had discussed it up to then; discussed it.

Q. Did you discuss how you were to buy in your interest?

A. Yes.

Q. And how were you to do that?

A. Mr. Lusthaus was to give me a gift of $50,000 and I was to give that as part payment of the business of the partnership and the balance in notes.

Q. I think you added a small part in cash of your own.

A. Yes, I added cash.

Q. About two hundred and some odd dollars?

A. (No response.)

Q. It was a small amount?

A. Yes.

Q. You didn't sell any of your securities or did you sell the house?

[fol. 40] A. No.

Q. You didn't sell any of your securities or the house to raise money to buy the business?

A. No.

Q. Do you recollect how much money, how much cash you had in your bank account on December '39 or January of 1940?

A. In December; how much cash?

Q. If you know?

A. No, I don't recollect.

Q. Was it a substantial amount?

A. I couldn't say; I don't know.

Q. Under the terms of the partnership, how were you to share profits and losses with your husband, in what proportion?

A. Fifty per cent; half.

Q. Half each?

A. Yes.

Q. I hand you a document and ask you what that is?

A. That is a tax return for 1938.

Q. Does your signature appear there?

A. No. Yes, there it is, right up there, for 1938 (indicating).

Q. That was filed with the Commissioner by you?

A. Why, yes.

Q. I hand you another document and ask you what that document is?

A. 1939 tax return.

Q. Does your signature appear thereon?

A. Yes.

Mr. McFarland: Respondent seeks to introduce in evidence as Exhibits E and F the individual tax returns filed [fol. 41] by Lillian Lusthaus for the year 1938 and 1939.

Mr. Wallerstedt: I would like to ask for the reason why these should go in. They seem to be immaterial to me.

Mr. McFarland: I think they are material in this respect. I seek to show that Mrs. Lusthaus's financial condition as evidenced by the income tax returns prior to the date of the so-called articles of partnership and prior to the agreement that she has testified was entered into between herself and her husband. I think it all goes into the whole picture to give your Honor the full picture of the status and the relationship between the two individuals.

* * * Omission from Transcript Page 55.

By Mr. McFarland:

Q. Mrs. Lusthaus, have you had any dealings with any credit agencies?

A. No.

Q. Your husband handles all that?

A. My husband takes care of that.

Q. What do you do now with relation to the company, if anything?

A. Just go into the store, into one of the stores, particularly, and just do what is necessary; wait on trade, as I said; do what I have to do there; anything that needs to be done; wait on trade and cashier.

Q. The same you have always done?

A. Same as I have always done; yes.

Mr. McFarland: I believe that is all.

Mr. Wallerstedt: That is all, Mrs. Lusthaus.

(Witness excused.)

[fol. 42] Ross C. Tenney, called as a witness in behalf of the Petitioner, being duly sworn, testified as follows:

The Court: Please give your name and address to the stenographer.

The Witness: Ross C. Tenney, Uniontown, Pennsylvania.

Direct examination.

By Mr. Wallerstedt:

Q. Your name is Ross C. Tenney?
A. That's right.
Q. What is your business?
A. Public accountant.
Q. Where do you practice?
A. In Uniontown and vicinity.
Q. How long have you been in the public accounting business?
A. Since 1927.
Q. You operate your own business?
A. Yes, sir.
Q. Do you know Mr. Lusthaus, the taxpayer petitioner in this case?
A. I do.
Q. Has he ever retained your services as an accountant?
A. Yes, sir.
Q. For how many years; if you remember?
A. Seven or eight years.
Q. Do you audit his books, the partnership books, and his books prior to——
A. Yes.
Q. Are the partnership books in this room?
[fol. 43] A. Yes.
Q. Do you know who keeps these books and records?
A. Yes, sir.
Q. Will you please state?
A. His bookkeeper keeps the detailed records and our office keeps the general ledger.
Q. You mean your office makes all the entries in this general ledger?
A. In this general ledger.
Q. Back in 1939, did you do some work for Mr. Lusthaus?
A. I did.
Q. Can you explain what that work was?

A. Mr. Lusthaus contemplated entering into a partnership and he asked me to prepare his statement showing the value of the property—the proprietorship—as it stood at that time.

Q. And did you make such a statement?

A. I did.

Q. I show you Petitioner's Exhibit No. 4, which has attached thereto an exhibit. Will you please tell me what that exhibit is?

A. That is a balance sheet of the business of the Household Furniture Company then owned entirely by Mr. Lusthaus as of December 31, 1939.

Q. Is that the statement that you prepared?

A. It is.

Q. Do you recall when you prepared that statement?

A. Sometime in January of 1940.

Q. Besides making up this statement of the individual business, did he instruct you in any other way?

[fol. 44] A. Yes, he also instructed me to prepare a statement reflecting the condition of the business after it would be divided into two equal parts.

Q. Did he ask you to open up any books or new books?

A. He asked me to prepare the books on a partnership basis beginning as of January 1.

Q. And did you do that?

A. I did.

Q. And when were you there making these entries?

A. The entries were made in our own office sometime in January.

Q. Of what year?

A. Of 1940.

Q. Can you tell me why you didn't open up a new set of books rather than use the old books?

A. Well, it was simple—it was a simple matter to simply close out on the proprietorship account of A. L. Lusthaus and close out the individual investment account and make up accounts for two partners in the same set of books.

Q. That saved the cost of——

A. Opening a new set of books.

Q. What type of entries did you make? I am not asking about the actual entries but what type of entries did you make in these books to reflect the partnership?

A. Journal entries.

Q. Journal entries. And what were those journal entries?

A. I made a journal entry closing out the "investment" accounts of A. L. Lusthaus and opening an "investment" account for A. L. Lusthaus and L. C. Lusthaus. I believe [fol. 45] that is the way they are reflected on the books.

Q. Did you close up the books of Mr. Lusthaus for the year 1939?

A. I did.

Q. Did you prepare the partnership returns, tax returns for 1940 and the return of the partners?

A. I did.

Q. Did you prepare a gift tax return for Mr. Lusthaus?

A. I did.

Q. I show you a paper marked Respondent's Exhibit A and ask you what that is?

A. That is a gift tax return for the calendar year 1940 for A. L. Lusthaus.

Q. Did you prepare this return?

A. I did.

Q. I direct your attention to the second page showing a gift of cash of $50,000 listed here as January 1, 1940. Do you have anything to say about that?

A. We simply—I made the return as of the date that the partnership was effective although the money was not actually transferred until a later time.

Q. You didn't have any purpose at all of putting that on——

A. None whatever.

Q. At my request, have you recently prepared certain statements from the books and records of the partnership and of the individual?

A. Yes, sir.

Q. I show you a paper and ask you what that is?

A. That is a balance sheet of the Household Furniture Company as of December 31, 1939.

[fol. 46] * * * Omission from Transcript p. 61.

By Mr. Wallerstedt:

Q. I show you another paper and ask you what that is?

A. That is a balance sheet of the Household Furniture Company as of January 1, 1940.

Mr. Wallerstedt: I offer in evidence the balance sheet of January 1, 1940, of the Household Furniture Company.

Mr. McFarland: No objection.

The Court: That will be marked Petitioner's Exhibit 9 and received.

(Balance sheet of the partnership as of 1/1/40 was received in evidence and marked Petitioner's Exhibit 9 of this date.

By Mr. Wallerstedt:

Q. I show you another paper and ask you what that is?

A. That is the balance sheet of the Household Furniture Company as of May 31, 1940.

Q. All these papers I am referring to have been prepared by you?

A. Yes, sir.

Q. From the books and records of the Household Furniture Company?

A. Yes, sir.

* * * Omission from Transcript pages 62 and 63.

By Mr. Wallerstedt:

Q. I show you a paper and ask you what that is?

A. That is a balance sheet of the Household Furniture Company as of December 31, 1940.

Mr. Wallerstedt: I offer in evidence the balance sheet of the Household Furniture Company as of December 31, 1940.

[fol. 47] Mr. McFarland: No objection.

The Court: It will be received as Petitioner's Exhibit 11.

(Balance sheet of the Household Furniture Co. as of 12/31/40 was received in evidence and Marked Petitioner's Exhibit 11, of this date.)

* * * Omission from Transcript pages — and —.

By Mr. Wallerstedt:

Q. I show you another paper and ask what that is?

A. That is a statement of income, profit and loss for the period June 1 to June 30, 1940 of the Household Furniture Company.

* * * Omission from Transcript Page 65.

By Mr. Wallerstedt:

Q. I show you another paper and ask you what that is?

A. That is an analysis of the investment accounts from January 1, 1940 to December 31, 1940, showing the details of the various entries to those accounts for that period.

Mr. Wallerstedt: I offer in evidence analysis of investment accounts for the period from January 1, 1940 to December 31, 1941, of the Household Furniture Company.

Mr. McFarland: No objection.

The Court: Received as Petitioner's Exhibit 15.

(Analysis of investment accounts for 1/1/40 to 12/31/41 of the Household Furniture Company was received in evidence and marked Petitioner's Exhibit 15, of this date.)

[fol. 48] By Mr. Wallerstedt:

Q. I show you another paper and ask you what that is?

A. That is an analysis of the withdrawals made by the partners from January 1, 1940 to December 31, 1940, showing what the withdrawals were made for.

Mr. Wallerstedt: I offer in evidence analysis of withdrawals of Mr. and Mrs. Lusthaus for the period from January 1, 1940 to December 31, 1941.

Mr. McFarland: No objection.

The Court: Received as Petitioner's Exhibit 16, and marked.

(Analysis of withdrawals of Mr. and Mrs. Lusthaus from 1/1/1940 to 12/31/1941 was received in evidence and marked Petitioner's Exhibit 16, of this date.)

By Mr. Wallerstedt:

Q. I show you Petitioner's Exhibit 15 and also Exhibit 16, and ask you if Exhibit 16 is a detail of entries shown in Exhibit 15?

A. No, sir. This is an analysis of the withdrawal accounts. That was the final total that was posted to the investment account itself, whereas the final result is posted to the investment account.

Q. In other words, they charge all withdrawals to the individual accounts and——

A. Then any debits or credits for withdrawals or loans to the business of money or anything of that kind is run through a personal account or so-called withdrawal account.

Q. That is Exhibit 16?

A. That's right. Then at the end of the year that account is either debited or credited to the investment account.

[fol. 49] Q. So that the amount here on Exhibit 16 shows, less cash advances by partner, or being a net figure of $4,604.76 as the amount that appears on this?

A. That is correct.

Mr. Wallerstedt: You may cross-examine.

Cross-examination.

By Mr. McFarland:

Q. Mr. Tenney, regarding the gift tax return that you have prepared for Mr. Lusthaus, that you stated you entered thereon, the gift was made January 1, 1940?

A. That's right.

Q. Why did you handle it in that fashion when the actual transfer of the money didn't occur until some six months later?

A. As I explained in my answer, I said that that was done as of the date of the beginning of the partnership and didn't think it made any difference. I didn't have any particular reason behind doing that except that was the date it should have been done and wasn't done.

Q. Are you familiar with the terms of the agreement of the bill of sale and the agreement of the articles of partnership?

A. I read it. I wouldn't say I am familiar with it; no.

Mr. McFarland: I believe that is all.

Mr. Wallerstedt: That's all.

(Witness excused.)

[fol. 50] Joseph W. Ray, Jr., called as a witness in behalf of the Petitioner, first being duly sworn, testified as follows:

The Court: Please give your name and address to the stenographer.

The Witness: Joseph W. Ray, Jr., Fayette Title and Trust Building, Uniontown, Pennsylvania.

Direct examination.

By Mr. Wallerstedt:

Q. Mr. Ray, what is your business?

A. I am a lawyer.

Q. How long have you practiced law?

A. A little more than 30 years; since September 1913.

Q. Can you tell us when you were admitted?

A. I have been admitted to the Appellate Courts of Pennsylvania and the Supreme and Superior Courts; the Court of the Common Pleas of Fayette County, Pennsylvania; the United States District Court for the western district of Pennsylvania; the Circuit Court of Appeals for the Third Circuit, and to this Tax Court—Federal Tax Courts.

Q. Do you know Mr. Lusthaus, the petitioner in this case?

A. I do.

Q. Is he your client?

A. He is.

Q. How long has he been your client?

A. I think since about January 1, 1938. Judge W. Russell Carr was Mr. Lusthaus's attorney until Judge Carr went on the bench. I think he was elected in '37 and since that time I have represented Mr. Lusthaus.

[fol. 51] Q. I show you Petitioner's Exhibit 4 and Exhibit 1 and ask you if you prepared those documents?

A. I did. They were executed in my office in my presence.

Q. Will you please state how you came to prepare these documents?

A. The negotiations leading up to the preparation of those documents began, so far as I am concerned, in either June or July 1939. At that time Mr. Lusthaus came and consulted me in regard to making his wife a partner in his business. I had a number of talks with him and it was determined that he would sell one-half interest in the business to his wife, that a partnership agreement would be entered into effective as of July 1, 1939. Such an agreement was prepared some time in the fall of 1939, which was in substance practically the same as the agreement that was subsequently signed in June 1940, effective as of January 1, 1940. The agreement prepared in 1939, however, was not executed because after consultation with Mr. Lusthaus and after consultation with Mr. Tenney, he rather

advised that it would be much better to make the change as of the first of January, 1940. It was then decided not to do that and the agreement that I first prepared some time in the fall of 1939 was not executed and the change was made later as of January 1, 1940.

Q. Do you remember what reason Mr. Tenney gave?

A. Well, it was decided, I think, largely on my advice, that the consideration for the agreement should be the book value of the business. There would be an inventory made as of the close of business of the 31 of December. There wasn't any physical inventory made as of June 30, and therefore Mr. Tenney thought it would work out from [fol. 52] a bookkeeping standpoint much better to make the change at the beginning of the calendar year rather than in the middle of the calendar year. That is my recollection of what Mr. Tenney told me.

Q. Why were these partnership—What instructions did Mr. Lusthaus give to you with respect to these partnership agreements and any other legal papers?

A. Well, he instructed me to prepare them after many consultations in my office. Mr. Lusthaus's place of business is in the same building as is my office. I saw him very frequently during the summer and fall of 1939. I suppose this matter was discussed thirty times between Mr. Lusthaus and myself. It was—he first talked about making a gift to his wife of an entire half interest in the business but after consultation he decided that taking into consideration all of his financial affairs, that it wasn't advisable to do that and then this plan that was carried out was decided upon by which he was to make the gift of the $50,000 and she was to buy the half interest, paying for it with the $50,000, the subject of the gift, plus the 11 notes, totaling the balance of the consideration.

Q. Did he tell you when to make these papers, these partnership agreements, effective?

A. He first told me——

Mr. McFarland: If the Court please, I object to the question. The articles of partnership have been introduced and the dates speak for themselves. What Mr. Lusthaus intended, I don't think is an issue.

The Court: I don't think he asked for an intention. Objection overruled.

The Witness: He told me in the first instance that they [fol. 53] were to be prepared and made effective as of June 30, 1939, and they were so prepared.

By Mr. Wallerstedt:

Q. Subsequent to that?

A. After our numerous conferences with Mr. Tenney I was instructed to prepare the papers which were to become effective as of January 1, 1940.

Q. The papers show that they were executed, I believe, on June 4, of 1940.

A. That's correct.

Q. Why were they not prepared as of, say, in December, so that they would become effective right on the date they started the partnership?

A. Mr. Wallerstedt, all that I can say about that is that it is entirely my responsibility. I became ill in December 1939. In January—through December *in* January I was not feeling very well. I am subject to colds and I have had pneumonia a number of times, and I was laid up with the grippe and the papers were not prepared.

Early in January of 1940 I decided to go away. Mrs. Ray and I got ready to go to Mexico; largely because I had been ill. My recollection is we planned to leave Uniontown the 17th or 18th of January, but about the time I was to leave or possibly the day before I was to leave, L. J. Hughes, of Fayette County, who was a client of our office, became ill in New Mexico and a few days later died out there and I determined that I should stay in Uniontown until his body was brought back and the burial services were held, and I did that.

I left Uniontown, I think, on the 24 or 25 of January. Mrs. Ray and I drove to Mexico City. We got back to Uniontown about the first of March. Either about that time or within a day or two, or a few days after, we re- [fol. 54] turned to Uniontown and Mr. Lusthaus left for Florida.

Q. Alone?

A. I am not sure. I think his wife went with him. I think they both went. I am sure they did. He was gone four or five or six weeks. During that time, my recollection is that some work was done on these papers and they were finally prepared and when he came back he was called

to my office and he and his wife came in and they were checked up again and possibly some corrections made and they were finally, at long last, signed and executed on the 4th of June, also in my office.

Q. Did you, at the time that you became sick and found it necessary to postpone drawing up these papers, did you in any way advise Mr. Lusthaus as to the partnership?

A. I did. I told him, Mr. Lusthaus, and also told Mr. Tenney—had a full and complete understanding—that the change was to be made and that the papers were to be prepared subsequently, effective as of January 1, 1940. Mr. Tenney was to make the change in the books, and I never saw the books, but I understood that that had been done prior to the time I left home to go to Mexico.

Q. Mr. Ray, in your opinion as a lawyer, and under the laws of the State of Pennsylvania, was this partnership agreement that was signed on June 4, 1940 effective as of January 1, 1940?

Mr. McFarland: I object, if the Court please.

The Court: Objection sustained.

Mr. Wallerstedt: I will withdraw the question.

By Mr. Wallerstedt:

Q. Is the partnership your client at the present time?

[fol. 55] A. It is.

Q. Do you know whether or not the affairs of the partnership have been conducted as a partnership since January 1, 1940, publicly?

Mr. McFarland: I object.

Mr. Wallerstedt: I ask him if he knows.

Mr. McFarland: I object to the question, your Honor. That is one of the ultimate issues in the case: whether or not the partnership has been conducted publicly as a partnership or as a sole proprietorship or in what fashion.

The Court: Objection overruled.

The Witness: I do.

By Mr. Wallerstedt:

Q. Will you state some of the acts that were done by the partnership which would lead you to that answer?

A. Well, the two partners signed the partnership agreement. I have, on numerous occasions, talked to both Mr.

Lusthaus and Lillian C. Lusthaus. At their request I filed sometime in 1940 ficticious name certificates both with the Secretary of the Commonwealth and with the Prothonotary of the Court of Common Pleas of Fayette County, stating that they were engaged in business as partners. Those certificates being signed by both of them, and, I believe, and both acknowledged and sworn to.

I know from my connection with the business that when they institute proceedings for recovery of furniture that's been sold on bailment leases, that those proceedings are in the name of the partnership. I know that any other proceedings I have are instituted that way. I know that so far as all the legal aspects of the business are concerned, it is [fol. 56] conducted as a partnership.

Q. I show you a paper and ask you what that is?

A. That is a certificate doing business under fictitious name, filed, issued by the deputy secretary of the Commonwealth to A. L. Lusthaus and Lillian Lusthaus, authorizing them to engage in the business under the fictitious name, Household Furniture Company.

Mr. Wallerstedt: I offer in evidence the certificate of the Commonwealth of Pennsylvania, under the Fictitious Names Act authorizing Mr. and Mrs. Lusthaus to operate under the assumed or fictitious names of the Household Furniture Company.

The Court: What is the date of that certificate?

Mr. Wallerstedt: This certificate is dated July 31, 1940.

Mr. McFarland: No objection.

The Court: That will be received as Petitioner's Exhibit 17.

(Certificate of doing business under fictitious name of partnership dated 7/31/40 received in evidence and marked Petitioner's Exhibit 17, of this date.)

By Mr. Wallerstedt:

Q. I show you a similar paper and ask you what that is?

A. That is a certificate issued by the deputy secretary of the Commonwealth to A. L. Lusthaus and Lillian Lusthaus authorizing them to do business under the fictitious name of the Furniture Outlet Store, place of business, Uniontown.

Q. And that is dated July 31, 1940?
[fol. 57] A. That is correct.

* * * Omission from Transcript pages 77 and 78.

By Mr. Wallerstedt:

Q. I show you another paper and ask you what that is?
A. That is a certificate of John J. Brady, Prothonotary of Fayette County, stating that the fictitious name certificate has been filed by A. L. Lusthaus and Lillian Lusthaus doing business as the Furniture Outlet Store.
Q. And that is dated——
A. August 1, 1940.

* * * Omission from Transcript pages 78 and 79.

By Mr. Wallerstedt:

Q. I show you another paper and ask you what that is?
A. That is a certificate issued by John J. Brady, Prothonotary of Fayette County, to A. L. Lusthaus and Lillian Lusthaus, certifying that they have filed fictitious name certificate for the purpose of doing business as Household Furniture Company, 52 West Main Street, Uniontown, Pennsylvania.

* * * Omission from Transcript page 79.

By Mr. Wallerstedt:

Q. You state that you filed applications for these certificates, did you not?
A. That is right.
Q. Why did you not file those applications earlier?
A. Well, for the same reason that there was a delay in getting the matter closed, and I had quite a delay in filing these certificates. I can't answer that. I don't know.
Q. When you filed your application you attached to that [fol. 58] application a copy of the partnership agreement?
A. You do not. They are made out, Mr. Wallerstedt, on a form that is a different or separate form, furnished by the Prothonotary, and the other is a form furnished by the Secretary of the Commonwealth.

Mr. Wallerstedt: That's all. You may cross-examine.

Cross-examination.

By Mr. McFarland:

Q. Mr. Ray, the actual transaction whereby Mrs. Lusthaus purchased in the business was consummated some time in June of 1940; is that right?

A. Yes, that is what I learned about.

Q. I refer at the time Mr. Lusthaus actually made a transaction whereby he issued a check to her?

A. That is correct. That was in June of the same time the agreement was actually signed.

Q. That is right. And she issued her check to him for the part of the purchase price plus the execution of the 11 notes?

A. That's right.

Q. All that occurred in June of 1940?

A. That's correct.

Mr. McFarland: That is all.

Mr. Wallerstedt: Petitioner rests.

Mr. McFarland: I have just one witness, if the Court please.

(The witness was excused.)

[fol. 59] F. W. Ries, Jr., called as a witness in behalf of the Respondent, first being duly sworn, testified as follows:

Direct examination.

By Mr. McFarland:

Q. What is your name?

A. F. W. Ries, Jr.

Q. Where do you live?

A. 1150 Union Trust Building, Pittsburgh, Pennsylvania.

Q. What is your profession?

A. Well, I am the manager of the Canada Life Assurance Company and I am also a member of the Bar of Allegheny County.

Q. When did you first meet Mr. A. L. Lusthaus of Uniontown?

A. My first meeting was about 1932.

Q. In what capacity did you meet him?

A. Our Mr. Boggs, one of our representatives, was talking to Mr. Lusthaus about setting up his estate with a view

of selling him insurance if he hadn't enough to take care of his taxes.

Q. Directing your attention to September of 1939, did you have a meeting with him at Uniontown?

A. Yes, we did.

Q. What was the date of that meeting?

A. September 19 was one meeting. I think we had a meeting previous to that, perhaps a week or so. I wouldn't be able to tell you exactly.

Q. Were those meetings at the request of Mr. Lusthaus?

A. Well——

[fol. 60] Q. Did he write to you asking that you come down to Uniontown?

A. No; I don't think he did. Perhaps he did. I wouldn't want to say. Mr. Boggs and he were discussing this matter. It had come up again in May of that year and Mr. Boggs and he had discussed the matter and it was understood that I was to go down to see him and whether he wrote or we wrote him, I don't know; I couldn't tell you that.

Q. Referring to the meeting of September 19 and the meeting, you say, of September 21——

A. No, September 19. There was one prior to that, too.

Q. September 19, 1939, did you meet with Mr. Lusthaus and Mr. Tenney in Uniontown?

A. Yes. Mr. Boggs and I met with him.

Q. And what was discussed during that meeting?

A. Well, my best recollection is that the meeting that we first had with Mr. Lusthaus—at that meeting we gave him some information concerning the gift taxes and we suggested that he take it up with his accountant and attorneys.

Q. May I interrupt. What was the nature of that information that you gave him?

A. Well, it was just how the gift tax operated with reference to the amount that he could give away and what the taxes were if he wanted to give away more. My best recollection is that Mr. Tenney didn't quite understand the situation as we explained it to Mr. Lusthaus and he made an appointment for us to see Mr. Tenney and discuss the thing with him and this meeting of September 19 was with relation to that.

Q. When you returned to Pittsburgh did you transcribe [fol. 61] the results of your meeting and what was discussed?

A. I dictated a memorandum; yes, sir.

Q. Do you have that memorandum with you?

A. I have the memorandum here.

Q. Using that memorandum as a means of refreshing your recollection, what were the actual conditions that you worked out at that meeting?

A. Well, we explained the way the gift tax and the exclusion worked and then it was understood that Mr. Lusthaus was to consult his attorney and the suggestion was made that he give Mrs. Lusthaus a gift up to at least the extent of the gift tax and then she was to take some of her own money and add to it and buy an interest in his business. That was the——

Q. She was to use the gift that Mr. Lusthaus was going to give her? Under the terms of your suggestion she'd buy into the business?

A. She was to use that and then add some of her own money to it. I think the memorandum states that very clearly.

Q. May I ask you how you arrived at the value of $200,000, and the business was valued at $200,000?

A. I think, perhaps we got that information from Mr. Tenney or Mr. Lusthaus.

Q. Do you know what elements entered into that value?

A. No, I do not, except that we may have had a balance sheet. I don't remember that.

Q. Was Mrs. Lusthaus present at the meeting?

A. At that meeting; no, sir.

Q. Was Mrs. Lusthaus present at any subsequent meeting?

[fol. 62] A. Not that we had with Mr. Lusthaus, that I remember.

Q. Has Mrs. Lusthaus been present at any meeting that you had with Mr. Lusthaus wherein you discussed the partnership agreement or the facts that lead up to the suggestions that you made to Mr. Lusthaus?

A. I think we met Mrs. Lusthaus once or twice in the store and it might have been there that Mr. Lusthaus explained to her the situation. I haven't that very clearly in my mind.

Q. When you explained the situation to Mrs. Lusthaus on these chance meetings in the store, what do you mean by "explained the situation?"

A. Well, he wanted us to explain about it. I think, in the first place, he wanted us to advise her to make a will. I think that he recommended that she do that, and I think that there might have been some questions asked about that. I am not

very clear on that and I shouldn't like to make a statement because I don't remember that.

Q. Mr. Ries, what was the end result to be gained by the formation of the partnership, the gift, and the various other transactions that you advised?

A. Well, when we talked to Mr. Lusthaus we made an analysis of his estate to show him how much ready cash would be necessary to pay off his taxes and the administration of the estate, and we suggested that he divide his estate. Now, that is what we first discussed with him.

Q. You were regarding his estate from a tax viewpoint; is that correct?

A. Yes, sir.

Mr. Wallerstedt: Isn't it a fact that you were trying to sell him insurance?

[fol. 63] The Witness: Yes, sir.

Mr. McFarland: That's all.

Mr. Wallerstedt: Just a minute, please.

Cross-examination.

By Mr. Wallerstedt:

Q. Mr. Ries, did you first call on Mr. Lusthaus, you say back in 1932?

A. Yes, sir.

Q. Your purpose at all times was to have been to sell him insurance?

A. That was the purpose.

Q. And you were then trying to have him set up his affairs in such a way that you could as a selling point for insurance?

A. Well, we were trying to help him set up his estate in the best advantage of his family, and we wanted to sell him insurance in order that there would be enough cash to keep his case liquid.

Mr. McFarland: Respondent rests.

Mr. Wallerstedt: That's all.

(Witness excused.)

* * * Omission from Transcript page 87.

[fol. 64] EXHIBIT No. 1

ARTICLE OF AGREEMENT

Made and entered into this 4th day of June, 1940, by and between Abraham L. Lusthaus and Lillian Lusthaus, both of the City of Uniontown, Fayette County, Pennsylvania, hereinafter sometimes referred to as "Partners", and individually as "Partner."

Whereas, the said Abraham L. Lusthaus has heretofore owned and operated a retail furniture and household furnishings business at 52 West Main Street in the City of Uniontown, Fayette County, Pennsylvania, known as Household Furniture Company, and a similar business at 31 Pittsburgh Street, in the said City of Uniontown, known as Furniture Outlet Store; and

Whereas, by Bill of Sale bearing even date herewith, but effective as of January 1, 1940, Abraham L. Lusthaus has sold and conveyed to the said Lillian Lusthaus an undivided one-half interest in and to said retail furniture and household furnishings businesses; and

Whereas, the parties hereto are now seized as tenants in common, without right of survivorship, of all the property and assets of said business known as Household Furniture Company, and business known as Furniture Outlet Store; and

Whereas, the parties hereto have agreed to engage in the retail furniture and household furnishings business and to operate said stores as Partners under the terms, conditions and provisions hereinafter set forth.

Now Therefore This Agreement Witnesseth, That in consideration of One ($1.00) Dollar in specie by each to the other in hand paid, the receipt whereof is hereby acknowl-
[fol. 65] edged, and in consideration of the mutual covenants and promises hereinafter set forth, the Partners agree to associate themselves as Partners under the firm name and style of "Household Furniture Company", and "Furniture Outlet Store" for the purpose of dealing in furniture, hardware, household equipment, furnishings and other merchandise usually handled by furniture stores, at 52 West Main Street in the City of Uniontown, Fayette County, Pennsylvania, and at 31 Pittsburgh Street in said city, for the term beginning the 1st day of January, 1940, and ending the 1st day of January, 1955, under the terms of

this Agreement of Partnership unless same is terminated by agreement of the parties or by operation of law, viz:

1. All of the assets of the Household Furniture Company and Furniture Outlet Store heretofore owned by the said Abraham L. Lusthaus and which are now owned in equal shares, as tenants in common, by the above named Partners shall constitute the assets of this partnership.

2. It is understood and agreed that the capital of said partnership has a fair value as of January 1, 1940, of Two Hundred Ten Thousand, Five Hundred Seven and 62/100 ($210,507.62) Dollars after allowance made for cash withdrawal in the amount of Twenty Thousand ($20,000.00) Dollars, made by Abraham L. Lusthaus on January 12, 1940, and that each of said Partners have contributed one-half thereof.

3. It is agreed by and between the Partners hereto that they shall share equally in the profits of said partnership and in like manner said Partners shall equally bear and assume the losses of said partnership.

4. Upon the dissolution and liquidation of said partnership, the assets of said partnership at the time of said dis- [fol. 66] solution or liquidation shall be divided or apportioned equally between the Partners according to their respective capital interests or investments in the partnership, as shown by the books of the partnership as of the date of dissolution.

5. The parties hereto agree that during the continuance of said partnership that neither Partner shall, without the consent of the other, enter into any bond or judgment, or become bound as bail or surety, or give any note or accept or endorse any bill of exchange with or for any person or persons whatever, other than the Partner, in any sum or sums in excess of One Thousand ($1,000.00) Dollars in the aggregate, without the written consent of the other partner.

6. It is understood and agreed that the said Abraham L. Lusthaus shall have full charge of the operation of all of the business of said partnership and shall act as Manager thereof, with full power to employ and discharge such persons as he may think advisable and necessary in the proper conduct of said business. In all matters in connection with

the operation and management of said business the said Abraham L. Lusthaus shall be in full control and shall have the final decision.

7. There shall be had and kept during the continuance of the partnership just and true book accounts in which shall be set down in detail all matters and things that shall in any wise appertain to the business of the partnership, and each of the Partners shall at all times have free access thereto.

8. On the last day of each calendar year a general account or a statement shall be taken of all the assets and liabilities of the partnership, and of all dealings and transactions thereof during said calendar year as well as all [fol. 67] other matters and things which are usually included in accounts of like nature. In taking and preparing such statement or account, a just valuation shall be made of all items requiring valuation; merchandise shall be valued at cost or market value, whichever is lower; all leases and other receivables shall be valued at face amount less payments thereon, and all accounts, properly deemed by the said Abraham L. Lusthaus to be worthless shall be eliminated. No good will or other intangibles of any kind shall be included as an asset. Such account shall be entered in a book kept for that purpose, shall be signed by each of said Partners and when so signed shall be binding upon them, their heirs, representatives and assigns. The profits arising from the business as determined by such account shall immediately thereafter be entered on the books of the partnership and credited equally to the respective accounts of the said Partners. Said profits shall bear no interest. Profits may be withdrawn by the Partners at such times as both partners agree that said withdrawals may be made without injury to the welfare and expansion of the partnership business.

9. Under no circumstances shall one of the Partners sell or assign his interest or share in said partnership, or any part thereof, or in any manner pledge or encumber the same to any person or persons whomsoever, without the consent of the other Partner first obtained in writing. Any such assignment, sale, pledge or encumbrance made without the consent of the Partner shall constitute a breach of this agreement, and, at the option of the other Partner, shall ipso facto dissolve the partnership.

10. It is understood and agreed by and between the Partners that in case of the death of one of the Partners, [fol. 68] the surviving Partner shall, within thirty days thereafter, purchase the entire interest in the partnership of the Partner so dying for the price or sum of One Hundred Thousand ($100,000.00) Dollars to be paid within three years from the date of the death of the deceased Partner, with interest on said purchase price at the rate of 3% per annum until paid. In making this agreement the parties hereto intend that it shall constitute an absolute obligation on the part of the estate and personal representative of the Partner so dying to sell his interest to the surviving Partner for the price or sum above mentioned, and an absolute agreement and undertaking on the part of the surviving Partner to purchase the interest of the deceased Partner for said above mentioned price or sum, and in making this agreement the parties hereto do so with the full appreciation of the fact that the book value of said business may be substantially greater or substantially less than the consideration above stated.

11. Upon the dissolution of the Partnership a full and general account of the assets, liabilities and transactions of the partnership shall be taken, stated, copied and signed by both Partners; and if all the affairs of the partnership are adjusted and its debts paid and discharged, then, unless the Partners shall otherwise agree, the remaining assets of the partnership, including money, goods, merchandise, fixtures, accounts, and all other partnership property of every kind whatsoever shall be equitably and fairly divided equally between the Partners, and each of said Partners hereby agrees to execute all such instruments in writing as may be necessary for facilitating the collection of all partnership assets and the division thereof among the Partners according to their respective interests as above set forth; [fols. 69-70] as well as all writings which may be necessary for the mutual indemnity and release of the Partners.

12. It is understood and agreed by and between the parties hereto that all the terms, provisions and conditions of this Partnership Agreement shall be binding upon the said parties, their heirs, executors, administrators and assigns and every of them.

In Witness Whereof, the parties hereto have subscribed their names and attached their seals to this Agreement,

which has been executed in two counterparts, each of which shall be taken to be an original, the day and year first above written.

Signed, sealed and delivered in the presence of A. L. Lusthaus, Lillian Lusthaus. (Seal.)

Jos. W. Ray, Jr.
Bertha M. Radtke

COMMONWEALTH OF PENNSYLVANIA,
County of Fayette, ss:

On this 4th day of June, A. D. 1940, before me, a Notary Public in and for said state and county, personally came the above named Abraham L. Lusthaus and Lillian Lusthaus, parties to the foregoing Agreement, and acknowledged said Agreement to be their act and deed, and desired the same to be recorded as such.

Witness my hand and Notarial seal the day and year aforesaid.

Bertha M. Radtke, Notary Public. (Seal.) My commission expires March 7, 1941.

(Here follow 2 photolithographs, side folios 71-72, 73-74.)

FORM 1065
Treasury Department
Internal Revenue Service

UNITED STATES

Page 1

PARTNERSHIP RETURN OF INCOME 1940

(To be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)

Do Not Use This Space
(Auditor's Stamp)

For Calendar Year 1940

or fiscal year beginning ....., 1940, and ended ....., 1941
(File this return not later than the 15th day of the 3d month following the close of the taxable year)

(PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION)

HOUSEHOLD FURNITURE COMPANY
(Name)

52 EAST MAIN STREET
(Street and number)

UNIONTOWN FAYETTE PENNSYLVANIA
(Post office) (County) (State)

Business or Profession Household Furnishings

Do Not Use These Spaces

File Code .....

Serial No. 978611

District .....
(Date Received)

RECEIVED
Collector of Internal Revenue
PITTSBURGH, PA.
APR 30 1941

Items and Instructions No.	GROSS INCOME					
1.	Gross receipts from business or profession				$ 276,325	62
2.	Less cost of goods sold:					
	(a) Inventory at beginning of year	$ 37,161	90			
	(b) Merchandise bought for sale	158,932	09			
	(c) Cost of labor, supplies, etc.					
	(d) Total of lines (a), (b), and (c)	$ 196,093	99			
	(e) Less inventory at end of year	50,616	68		145,477	31
3.	Gross profit (or loss) from business or profession (item 1 minus item 2)				$ 130,848	31
4.	Income (or loss) from other partnerships, syndicates, pools, etc. (state separately name, address, and amount):					
5.	Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 6)				15,489	35
6.	Interest on tax-free covenant bonds upon which a Federal income tax was paid at source					
7.	Interest on Government obligations, etc. (From line (d), Schedule A)					
8.	Rents					
9.	Royalties					
10.	Net gain (or loss) from sale or exchange of property other than capital assets (from Schedule B)					
11.	DIVIDENDS Bad Debts previous year collected.				23,960	02
12.	Other income (state nature of income) Purchase Discounts				3,346	07
13.	Total income in items 3 to 12 (enter ascertainable income in Schedules A and C)					$ 173,643 75

HOUSEHOLD FURNITURE COMPANY
(Name)

52 EAST MAIN STREET
(Street and number)

UNIONTOWN FAYETTE PENNSYLVANIA
(Post office) (County) (State)

Business or Profession Household Furnishings

(Gross Receipts)

RECEIVED
Collector of Internal Revenue
PITTSBURGH, PA.
APR 30 1941

CASHIER'S COPY

Item and Instruction No.	GROSS INCOME					
1.	Gross receipts from business or profession			$ 376,325	62	
2.	Less cost of goods sold:					
	(a) Inventory at beginning of year	$ 37,161	90			
	(b) Merchandise bought for sale	158,932	09			
	(c) Cost of labor, supplies, etc.					
	(d) Total of lines (a), (b), and (c)	$ 196,093	99			
	(e) Less inventory at end of year	50,616	68	145,477	31	
3.	Gross profit (or loss) from business or profession (item 1 minus item 2)			$ 130,848	31	
4.	Income (or loss) from other partnerships, syndicates, pools, etc. (state separately name, address, and amount):					
5.	Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 6)			15,489	35	
6.	Interest on tax-free covenant bonds upon which a Federal income tax was paid at source					
7.	Interest on Government obligations, etc. (from line (d), Schedule A)					
8.	Rents					
9.	Royalties					
10.	Net gain (or loss) from sale or exchange of property other than capital assets (from Schedule B)					
11.	DIVIDENDS Bad Debts previous year collected.			23,960	02	
12.	Other income (state nature of income) Purchase Discounts			3,346	07	
13.	Total income in items 3 to 12 (enter ascertainable income in Schedules A and C)					$ 173,643 75
	DEDUCTIONS					
14.	Salaries and wages (do not include compensation for partners)			$ 42,372	17	
15.	Rent			11,265	00	
16.	Repairs					
17.	Interest on indebtedness (explain in Schedule F)			148	67	
18.	Taxes (explain in Schedule C)			2,640	98	
19.	Losses by fire, storm, shipwreck, or other casualty, or theft (submit schedule, see Instruction 19)					
20.	Bad debts (explain in Schedule D)			8,845	95	
21.	Depreciation (explain in Schedule E)			1,138	68	
22.	Depletion of mines, oil and gas wells, timber, etc. (submit schedule, see Instruction 22)					
23.	Other deductions authorized by law (explain in Schedule F)			26,952	10	
24.	Total deductions in items 14 to 23					93,363 55
25.	Ordinary net income (item 13 minus item 24)					$ 80,280 20
26.	Net short-term capital gain (or loss) (from line 1, column 4, Summary, Schedule H)					$
27.	Net long-term capital gain (or loss) (from line 2, column 4, Summary, Schedule H)					$

NOTE.—In order that this return may be accepted as meeting the requirements of the Internal Revenue Code, the data called for herein must be set forth FULLY and CLEARLY.

71-72

Exhibit No. 3. (Page 1.)

Schedule J.—PARTNERS' SHARES OF INCOME AND CREDITS. (See Instructions 28)

(a) (b) (c) (d) (e) (f) (g)	1. Name and address of each partner (Indicate corporations others). Where ownership of partners or members is filed in another collection district, specify district. If the full share of any partner was not divulged to the business, the percentage of share divulged must be stated	2. Ordinary net income (or loss) (Page 2, line 27, page 1, Schedule K, Column 2, line 12, page 1)		3. Net short-term gain (or loss) from sale or exchange of capital assets (From Schedule H, Summary, line 1, column 6)		4. Net long-term gain (or loss) from sale or exchange of capital assets (From Schedule H, Summary, line 2, column 6)	
(a)	A. L. Lusthaus	$ 40,140	10	$		$	
(b)	Lillian C. Lusthaus	40,140	10				
	Totals	$ 80,280	20	$		$	

CONTINUATION OF SCHEDULE J

(a) (b) (c) (d) (e) (f) (g)	5. Use letters in column (a) to identify partners	6. Wholly tax-exempt obligations (Sec. 22 (b) (4) and (5) of Revenue Act) (Schedule A)		Partially tax-exempt: 7. United States Savings Bonds and Treasury bonds (Sec. 22 (b) (4) Schedule A)		8. Obligations of certain instrumentalities of the United States (Sec. 22 (b) (5) Schedule A)		9. Earned income	10. Charitable contributions (From Schedule B)	11. Federal income taxes paid or accrued (See item 4, page 1)	12. Income and profits taxes paid to a foreign country or United States possession
		Principal	Interest	Principal	Interest	Principal	Interest				
(a)		$	$	$	$	$	$	$ 8,028 05	$ 568 00	$	$
(b)								8,028 05	568 00		
Totals		$	$	$	$	$	$	$ 16,056 10	$ 1135 99	$	$

QUESTIONS

1. Date of organization January 1, 1940
2. Nature of organization (partnership, syndicate, pool, joint venture, etc.) Partnership
3. Was a return filed for preceding year? No If so, to which collector's office was it sent?
4. Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
5. State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market, whichever is lower Cost

   If any other basis is used, attach statement describing basis fully, state why used and the date inventory was last reconciled with stock
6. Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or a personal holding company, as defined in section 501 of the Internal Revenue Code? (Answer "Yes" or "No") No

   If answer is "Yes," attach schedule required by Instruction I.
7. Was return of information on Forms 1096 and 1099 filed for the calendar year 1940? (See Instruction H) Yes

5. (a) Enter letter identifying partner	6. Wholly tax-exempt obligations (Sec. 22 (b) (4) and (5) of Schedule A)		7. Partially tax-exempt: United States Savings Bonds and Treasury Bonds (Sec. 22 (b) (4), Schedule A)		8. Obligations of certain instrumentalities of the United States (Sec. 22 (b) (5), Schedule A)		9. Earned income	10. Charitable contributions (From Schedule b)	11. Federal income taxes paid or accrued (For explanation of basis, see page 3)	12. Income and profits taxes paid to a foreign country or United States possession
	Principal	Income	Principal	Income	Principal	Income				
(a)	$	$	$	$	$	$	$ 8,028 05	$ 568 00	$	$
(b)							8,028 05	568 00		
Totals	$	$	$	$	$	$	$ 16,056 10	$ 1135 99	$	$

QUESTIONS

1. Date of organization January 1, 1940
2. Nature of organization (partnership, syndicate, pool, joint venture, etc.) Partnership
3. Was a return filed for preceding year? No. If so, to which collector's office was it sent?
4. Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
5. State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market, whichever is lower Cost

If any other basis is used, attach statement describing basis fully, state why used and the date inventory was last reconciled with stock

6. Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or a personal holding company, as defined in section 501 of the Internal Revenue Code? (Answer "Yes" or "No") No
If answer is "Yes," attach schedule required by Instruction I.
7. Was return of information on Forms 1096 and 1099 filed for the calendar year 1940? (See Instruction H) Yes

AFFIDAVIT (See Instruction D)

I swear (or affirm) that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return, made in good faith, for the accounting period stated, pursuant to the Internal Revenue Code and the regulations issued under authority thereof.

Subscribed and sworn to before me this 30th day of April, 1941

A. L. Lauckhaus
(Signature of taxpayer or member)

Carl B. Langford Notary Public
(Signature and title of officer administering oath) My Commission expires Jan. 7, 1945

(Address of partner or member)

(If this return was prepared for you by some other person, the following affidavit must be executed)

AFFIDAVIT (See Instruction D)

I/we swear (or affirm) that I/we prepared this return for the organization named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the income of the person for whom this return has been prepared of which I/we have any knowledge.

Subscribed and sworn to before me this

(Signature of person preparing the return)

(Address of person preparing the return)

TERRY AND COMPANY
(Name of firm or employer, if any)

30th day of April, 1941

Carl B. Langford Notary Public
(Signature and title of officer administering oath) My Commission expires Jan. 7, 1945

16—17871

73-74

Exhibit No. 3.
(Page 4.)

5218

[fol. 75] EXHIBIT No. 4

Know All Men by These Presents, That I, Abraham L. Lusthaus of the City of Uniontown, Fayette County, Pennsylvania, for and in consideration of the sum of One Hundred Five Thousand, Two Hundred Fifty-three and 81/100 ($105,253.81) Dollars paid in the manner hereinafter set forth, the receipt whereof is hereby acknowledged, do hereby grant, bargain, sell, transfer and deliver unto Lillian Lusthaus of the said City of Uniontown, all the following property, to-wit:

The undivided one-half interest in the stock of merchandise, trucks, delivery equipment, office furniture and all other property, including merchandise in transit or stored in any warehouse, comprising the business now owned and operated by me at 52 West Main Street in the City of Uniontown, Pennsylvania, under the trade name Household Furniture Company, and the similar business now owned and operated by me at 31 Pittsburgh Street in the said City of Uniontown, under the trade name Furniture Outlet Store, also an undivided one-half interest in and to all all accounts receivable, bailment leases and other evidences of indebtedness now owing to me as the owner of said businesses.

The property, merchandise rights, credits, etc. above mentioned are sold subject to the payment by the said Lillian Lusthaus of one-half of all debts and liabilities of said businesses, including bills payable, rent, taxes and other liabilities as shown by the books of account of said businesses and as determined by Ross C. Tenney, Public Accountant of the City of Uniontown, said county and state, who is now acting as Auditor and Accountant for said businesses.

[fol. 76] The consideration hereinabove mentioned, to-wit, the sum of One Hundred Five Thousand, Two Hundred Fifty-three and 81/100 ($105,253.81) Dollars has been paid by the said Lillian Lusthaus in the following manner, to-wit, the sum of Fifty Thousand, Two Hundred Fifty-three and 81/100 ($50,253.81) Dollars cash in hand paid, upon the signing of this Bill of Sale, the receipt of which is hereby acknowledged, and the sum of Fifty-five Thousand ($55,000.00) Dollars in eleven (11) promissory notes of said Lillian Lusthaus of Five Thousand ($5,000.00) Dollars each, payable in one, two, three, four, five, six, seven, eight, nine,

ten and eleven years after date, respectively, and bearing interest at the rate of 3% per annum payable annually. The parties hereto declare and agree that the above mentioned consideration represents the full, fair value of the property and interest hereby conveyed as is set forth in financial statement of said businesses, prepared by Ross C. Tenney, Accountant, which is hereto attached, marked Exhibit "A" and made a part hereof. Said statement of the condition of said businesses is prepared as of December 31, 1939, except that the net worth or value of said businesses is reduced Twenty Thousand ($20,000.00) Dollars, being the amount of cash withdrawal made by said Abraham L. Lusthaus on January 12, 1940.

I, Abraham L. Lusthaus, hereby agree that the property and interest hereby sold and conveyed to the said Lillian Lusthaus shall constitute a part of her own separate estate and that from and after the execution of this Bill of Sale the said property and assets of said Household Furniture Company and said Furniture Outlet Store shall be owned by me and the said Lillian Lusthaus, as tenants in common [fol. 77] and not as joint tenants and not as tenants by entireties. It is the intention and agreement of Abraham L. Lusthaus in executing this Bill of Sale and in like manner it is the intention and agreement of Lillian Lusthaus in paying the consideration above mentioned and accepting delivery of this Bill of Sale that they shall own the assets of said retail furniture businesses as tenants in common and that upon the death of the said Abraham L. Lusthaus his undivided interest shall be an asset of his estate, and that, in like manner, upon the death of Lillian Lusthaus her undivided interest shall be an asset of her estate, without any rights of survivorship and in the same manner as if the said Abraham L. Lusthaus and the said Lillian Lusthaus were not married.

To Have and To Hold all and singular the goods and chattels hereinabove described to the said Lillian Lusthaus, her heirs and assigns to her own use and behoof forever. And the said Abraham L. Lusthaus hereby covenants with the said Lillian Lusthaus that he is the lawful owner of said goods and chattels and that they are free from all encumbrances, except as may be shown and indicated on his books of account; that he has the right to sell said goods and chattels and that he will warrant and defend the same against the lawful claims and demands of all persons.

This Bill of Sale and the transfer of ownership of said property, although executed the day and year hereinafter mentioned, shall be effective as of January 1, 1940, the parties hereto having actually agreed to said conveyance on or prior to that date.

[fol. 78] In Witness Whereof, the parties to this Bill of Sale have hereunto set their hands and seals the 4th day of June A. D. 1940.

A. L. Lusthaus, Lillian Lusthaus (Seal).

Witness: Jos. W. Ray, Jr., Bertha M. Radtke.

EXHIBIT "A" TO FOREGOING EXHIBIT

Household Furniture Company, Balance Sheet, December 31, 1939

Tenney and Company, Accountants and Auditors, Second National Bank Bldg., Uniontown, Pa.

Household Furniture Company Balance Sheet, December 31, 1939

Current Assets		
Cash	1,705.92	
Leases Receivable	195,161.01	
Merchandise Inventory	37,161.90	
Total Current Assets		234,028.83
Fixed Assets		
Delivery Equipment	5,705.12	
Office Equipment	3,417.45	
	9,122.57	
Less: Reserve for Depreciation	6,272.52	
Total Fixed Assets		2,850.05
[fol. 79] Deferred Charges		
Prepaid Insurance		455.61
		237,334.49

Liabilities and Capital

Liabilities		
Accounts Payable	17,431.38	
Accrued Liabilities	607.90	
Total Liabilities		18,039.28
Deferred Credits		
Realizable Profit		8,787.59
Capital		
A. L. Lusthaus, Investment		210,507.62
		237,334.49

Tenney and Company.

EXHIBIT No. 6

$5,000.00 January 1, 1940.

One Year after date I promise to pay to the order of Abraham L. Lusthaus Five Thousand ($5,000.00) Dollars Without defalcation, value received with interest at 3% per annum, payable annually.

And further, I do hereby empower any Attorney of any Court of Record within the United States or elsewhere to appear for me and after one or more declarations filed, confess judgment against me as of any term for the above sum with Costs of suit and Attorney's com- [fol. 80] mission of five per cent for collection and release of all errors, and without stay of execution and inquisition and extension upon any levy on real estate is hereby waived, and condemnation agreed to and the exemption of personal property from levy and sale on any execution hereon, is also hereby expressly waived, and no benefit of exemption be claimed under and by virtue of any exemption law now in force or which may be hereafter passed.

This note is one of a series of eleven notes in like amount, payable from one to eleven years after date, respectively, given by the maker to the above named payee, and in case default shall be made in the payment of the principal or interest due on the above note, then at the option of payee,

his heirs or assigns, all of said eleven notes shall forthwith become due and payable.

Witness my hand and seal.

Lillian Lusthaus (Seal).

Witness: Jos. W. Ray, Jr.

Stamped: Paid, A. L. L.

EXHIBIT No. 9

Household Furniture Company Balance Sheet, January 1, 1940

Assets

Current Assets		
Cash	21,705.92	
Leases Receivable	195,161.01	
Merchandise Inventory	37,161.90	
Total Current Assets		254,028.83
[fol. 81] Fixed Assets		
Delivery Equipment	5,705.12	
Office Equipment	3,417.45	
	9,122.57	
Less: Reserve for Depreciation	6,272.52	
Total Fixed Assets		2,850.05
Deferred Charges		
Prepaid Insurance		455.61
		257,334.49

Liabilities and Capital

Liabilities		
Accounts Payable	17,431.38	
Accrued Liabilities	607.90	
Advances by Partners	20,000.00	
Total Liabilities		38,039.28

Deferred Credits		
Realizable Profit		8,787.39
Capital		
A. L. Lusthaus, Investment	105,253.81	
L. C. Lusthaus, Investment	105,253.81	
Net Worth		210,507.62
		257,334.49

[fol. 82] EXHIBIT No. 11

Household Furniture Company

Balance Sheet

December 31, 1940

Assets

Current Assets		
Cash	23,278.12	
Leases Receivable	228,240.72	
Accounts Receivable	420.00	
Merchandise Inventory	50,616.68	
Total Current Assets		302,555.52
Fixed Assets		
Delivery Equipment	5,962.50	
Office Equipment	3,517.45	
	9,479.95	
Less: Reserve for Depreciation	5,328.58	
Total Fixed Assets		4,151.37
Deferred Charges		
Prepaid Insurance		516.23
		307,223.12

Liabilities and Capital

Liabilities		
Accounts Payable	20,594.61	
Accrued Liabilities	653.46	
Total Liabilities		21,248.07

[fol. 83] Capital

A. L. Lusthaus, Investment	140,714.94	
L. C. Lusthaus, Investment	145,260.11	
Net Worth		285,975.05
		307,223.12

EXHIBIT No. 15

Household Furniture Company

Analysis of Investment Accounts

January 1, 1940 to December 31, 1941

A. L. Lusthaus—Investment—January 1, 1940		105,253.81
Add: Profit for year 1940		35,672.10
Add: Transfer of Deferred Income		4,393.79
		145,319.70
Less: Withdrawals—1940		4,604.76
A. L. Lusthaus—Investment—December 31, 1940		140,714.94
Add: Profit for year 1941		31,871.98
Add: Bad Debts disallowed by Revenue Agent (1940)		1,501.20
		174,088.12
Less: Withdrawals—1941		19,198.69
A. L. Lusthaus—Investment—December 31, 1941		154,889.43

[fol. 84] L. C. Lusthaus—Investment—January 1, 1940 105,253.81

Add: Profit for year 1940		35,672.11
Add: Transfer of Deferred Income		4,393.80
		145,319.72
Less: Withdrawals—1940		59.61

L. C. Lusthaus—Investment—December 31, 1940	145,260.11
Add: Profit for year 1941	31,871.97
Add: Bad Debts disallowed by Revenue Agent (1940)	1,501.20
	178,633.28
Less: Withdrawals—1941	16,317.86
L. C. Lusthaus—Investments—December 31, 1941	162,315.42

* Transfer to investment accounts the Realizable Profit on Sales which was included in income of 1936 and 1938 by revenue agent in report dated October 14, 1940.

Exhibit No. 16

Household Furniture Company

Analysis of Withdrawals

January 1, 1940 to December 31, 1941

A. L. Lusthaus

1940

Cash Withdrawals		17,767.56
West Penn Power Company	68.38	
Donations	45.00	
Bell Telephone Company	68.80	
Fayette County Gas Company	780.10	

[fol. 85]

Uniontown Water Company	32.17
Doctors	178.00
Kaufman's, Gimbels, Hornes, etc.	289.09
Subscriptions	11.00

Collector of Internal Revenue	5,268.66	
Personal Insurance	96.00	
		6,837.20
		24,604.76
Less: Cash Advances by Partner		20,000.00
		4,604.76
1941		
Cash Withdrawals		9,157.50
Life Insurance	2,628.27	
Fayette County Gas Company	70.10	
West Penn Power Company	45.58	
Bell Telephone Company	53.37	
Donations	386.41	
Doctors	98.00	
Kaufman's, Gimbels, Hornes, etc.	55.32	
Other Insurance	182.64	
Collector of Internal Revenue	6,499.65	
City Treasurer	8.32	
County Treasurer	13.53	
		10,041.19
		19,198.69

[fol. 86] L. C. Lusthaus

1940		
Collector of Internal Revenue		59.61
1941		
Cash Withdrawals		8,907.50
Collector of Internal Revenue	7,115.04	
City Treasurer	254.82	
Donations	40.50	7,410.36
		16,317.86

IN THE TAX COURT OF THE UNITED STATES

Docket No. 112702

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Findings of Fact and Opinion—Promulgated March 29, 1944

Husband and Wife Partnership.—Petitioner entered into a partnership agreement with his wife in 1940 purporting to make her an equal partner in a furniture business which he had operated for a number of years. He gave her $50,000 which she immediately returned to him with her promissory notes for $55,000, and a negligible amount of her own funds, in payment of her one-half interest. Thereafter, she contributed no additional capital and rendered only casual services to the business, as she had always done. *Held,* that all of the profits of the business are taxable to petitioner as his individual earnings.

[fol. 87] W. A. Seifert, Esq., William Wallace Booth, Esq., Jos. W. Ray, Jr., Esq., Paul E. Hutchinson, Esq., and A. G. Wallerstedt, C. P. A., for the petitioner. W. J. McFarland, Esq., for the respondent.

The respondent has determined an income tax deficiency of $22,419.98 for 1940. The principal amount, and contested portion, of the deficiency results from the inclusion in petitioner's gross income of all of the profits of a furniture business which petitioner and his wife reported in equal shares as partnership income.

FINDINGS OF FACT

Petitioner is a resident of Uniontown, Pennsylvania. He filed his income tax return for 1940 with the collector of internal revenue for the twenty-third district of Pennsylvania.

For several years prior to 1940 petitioner operated as a sole proprietorship a retail furniture business at Uniontown, Pennsylvania. There were two stores, one known as Household Furniture Co. and one as Furniture Outlet Store.

During 1939 petitioner had several conferences with an accountant and an attorney of Uniontown to discuss the matter of making his wife an equal partner in his furniture business. It was decided in the latter part of that year that petitioner would "sell" to his wife a one-half interest in the business and make her an equal partner as of January 1, 1940. Petitioner instructed his accountant to determine the value of the business and make the necessary changes in the books of account and instructed the attorney to prepare the necessary legal papers.

[fol. 88] The net worth of the business, based on book value of all physical assets and inventory but not including good will, was determined to be $230,000. It was decided that petitioner would withdraw $20,000 from the business, leaving a net worth of $210,000; that he would make his wife a gift of $50,000 which she would use as part payment for her one-half interest and that for the balance, $55,000, she would give petitioner her promissory notes payable $5,000 annually. Petitioner told his wife of the plan and she agreed to it.

The formalities of the transfer were delayed, first by the illness of petitioner's attorney in December 1939, then by the absence of the attorney while he and his wife were on a visit to Mexico in January and February 1940, and finally by the absence of petitioner and his wife while they were on a visit to Florida in March and April 1940. A bill of sale was executed by petitioner on June 4, 1940, conveying to his wife a one-half undivided interest in his furniture business for a stated consideration of $105,253.81 which represented one-half of the estimated value of the business at December 31, 1939. A partnership agreement was executed by petitioner's wife on June 4, 1940. A few days later petitioner borrowed $25,000 from the bank and gave his wife a check for $50,000. This check was drawn against the funds previously withdrawn from the business and those borrowed from the bank. Petitioner's wife then gave petitioner her check dated June 18, 1940, for $50,253.81. She also executed and delivered to him eleven promissory notes for $55,000, as previously agreed upon, in payment of the balance of the purchase price for her interest in the partnership. At that time petitioner's wife owned her home valued at $25,000 or $30,000 and about $20,000 or $25,000 of securities. A certificate authorizing petitioner and his [fol. 89] wife to carry on business under the fictitious name

of Household Furniture Co. was issued by the Commonwealth of Pennsylvania on July 31, 1940.

Petitioner filed a gift tax return for 1940 in which he reported a gift to his wife of $50,000 on January 1, 1940.

Petitioner's furniture business was conducted in substantially the same manner after the consummation of the partnership arrangements as before. Petitioner continued to manage the business, as he was authorized to do under the partnership agreement. His wife helped out at the stores—or one of them—whenever she was needed just as she had always done. She took no active part in the management of the business. She never received any compensation for her services.

Prior to 1940 petitioner and his wife maintained a joint bank account. Some time in 1940 they opened separate accounts. A separate account was maintained for the business in the name of Household Furniture Co. During 1940 petitioner withdrew $4,604.76 from the business and his wife withdrew $59.61. In 1941 petitioner withdrew $19,198.69 and his wife $16,317.86. At the close of each year the profits of the business were credited in the books to petitioner and his wife equally.

A partnership return was filed in the name of Household Furniture Co. for 1940 showing a net profit of $80,280.20. Petitioner and his wife each reported one-half of that amount (less partnership contributions of $1,135.99) in their individual returns for 1940.

Petitioner's wife has paid three of the eleven promissory notes which she gave petitioner under the partnership agreement as they became due.

The respondent determined in his deficiency notice that no bona fide partnership existed between petitioner and his [fol. 90] wife in 1940 and that petitioner is taxable on all of the profits from his furniture business for that year. Those profits, with certain adjustments made in the deficiency notice which are not in controversy, amounted to $84,443.42.

In her individual income tax return for 1940 petitioner's wife claimed all of the personal exemption of $2,000 and petitioner claimed none in his return. Her return shows a gross income of $41,113.12 of which $40,140.10 was partnership income. Petitioner now contends that the entire amount of the personal exemption of $2,000 should be allowed to him instead of to his wife.

OPINION

SMITH, Judge:

We think that the respondent has correctly determined that petitioner is taxable on all of the profits from his furniture business in 1940. The evidence here discloses another of those superficial arrangements whereby a husband undertakes to make his wife a partner in his business for the obvious, if not the sole, purpose of reducing his income taxes.

The picture here is plainly drawn for us. About 1939 petitioner found himself confronted with the prospect of large earnings from his furniture business and the certainty of large income taxes. The matter of the taxes caused him concern. In his travail he sought the help of his accountant. Together they evolved the plan for the husband and wife partnership. Petitioner would "sell" to his wife a one-half interest in the business. He would make her a "gift" of a part of the purchase price and take her promissory notes for the balance. She could pay off the notes from her share of her profits of the business. He could raise the [fol. 91] money for the gift to her by withdrawing some of the surplus cash from the business and borrowing the balance from the bank. He could repay the bank out of her payments on the notes and his share of the partnership profits. An attorney was engaged to look after the legal phases of the plan. Finally, the partnership emerged from the metamorphosis clothed in the outer garment of legal respectability but inwardly perhaps a little uneasy over the flimsiness of its garment of income tax alleviation.

The formalities of executing the partnership agreement and registering the business with the Pennsylvania authorities as a partnership did not change petitioner's economic interests in the business. The wife acquired no separate interest of her own by turning back to petitioner the $50,000 which he had given her conditionally and for that specific purpose. The evidence shows that she had very little to do with the formation of the partnership. She testified that "On the evidence of counsel I did what he told me to do."

On facts similar to those in the present case we denied the existence of a partnership status for income tax purposes between a husband and wife in *Francis Doll*, 2 T. C.

276. Cf. *Francis E. Tower*, 3 T. C. —, promulgated March 3, 1944.

In *Schroder v. Commissioner*, 134 Fed. (2d) 346, the court referred to a comparable factual situation as "another of those efforts to make future returns from personal services taxable to some one other than the real earner of them." The income there resulted largely from the taxpayer's services and abilities as a mechanical and electrical engineer. Here the income resulted largely from petitioner's services and ability as manager of his furniture business and the employment of his capital in the business. [fol. 92] the question of the validity of the partnership under the laws of the state of its creation (Alabama) was not considered important in that case.

Whether or not the arrangement which petitioner made with his wife constituted a valid partnership under the laws of Pennsylvania we do not think it should be given recognition for Federal income tax purposes.

Petitioner now claims the right to the personal exemption of $2,000 which was claimed by his wife in her return for 1940. Apparently he makes this contention in anticipation of an adverse ruling on the question of the right of his wife to report one-half of the profits from his furniture business as partnership income.

We do not think that this claim is timely. The law permits a husband and wife to elect in what proportion they shall claim the personal exemption in their individual returns. Once having made an election they are not free to change their position to better advantage in the light of subsequent developments. There is nothing in this record to indicate that the claim of the personal exemption in the wife's return was due to any mistake or misunderstanding of petitioner's rights in the matter.

Decision will be entered for the respondent.

[fol. 93] IN THE TAX COURT OF THE UNITED STATES, WASHINGTON

Docket No. 112702

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION—Entered March 29, 1944

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion promulgated March 29, 1944, it is

Ordered and Decided: That there is deficiency in income tax for the calendar year 1940 in the amount of $22,419.98.

Enter: (Signed) Charles P. Smith, Judge. (Seal.)

Entered March 29, 1944.

[fol. 94] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1944

No. 8697

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appeal from the Tax Court of the United States

ORDER ASSIGNING HON. GUY L. FAKE FOR ARGUMENT—Filed December 7, 1944

And now, to-wit: this 7th day of December A. D. 1944, it is ordered that Hon. Guy L. Fake, District Judge, for the District of New Jersey, be, and he is hereby assigned to sit in above case in order to make a full court.

H. F. Goodrich, Circuit Judge.

[File endorsement omitted.]

[fol. 95] In United States Circuit Court of Appeals for the Third Circuit, October Term, 1944

No. 8697

A. L. Lusthaus, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

On Petition for Review of Decision of the Tax Court of the United States

Before Goodrich and McLaughlin, Circuit Judges, and Fake, District Judge

Opinion of the Court—Filed April 11, 1945

By McLaughlin, Circuit Judge:

The question presented is whether the asserted partnership of the taxpayer and his wife should be so recognized for federal income tax purposes. The year involved is 1940.

It is conceded for the petitioner that the facts as found by the Tax Court are substantially correct. Briefly these are: For several years prior to 1940, the petitioner owned and operated a retail furniture business, consisting of two stores, both in Uniontown, Pennsylvania. In 1939 petitioner conferred several times with an accountant and an attorney and it was decided that he would "sell" to his wife a one-half interest in his business and make her an equal partner as of January 1, 1940. The net worth of the business, excluding goodwill and after a withdrawal of $20,000 by peti- [fol. 96] tioner, was determined to be $210,000. Petitioner decided to make a gift to his wife of $50,000 so that she would have it as part of the purchase money for the one-half interest. After some delay, in June, 1940, the petitioner executed a bill of sale to his wife for a one-half undivided interest in his furniture business. The stated consideration was $105,253.81, representing one-half of the estimated value of the business on December 31, 1939. Mrs. Lusthaus, at or about the same time, executed a partnership agreement. A few days later the petitioner borrowed $25,000 from a bank. He gave his wife a check for $50,000 which

sum was made up from the proceeds of the loan and from money previously withdrawn from the business. Then Mrs. Lusthaus gave petitioner her check for $50,253.81 together with eleven promissory notes totalling $55,000, as the purchase price. At that time Mrs. Lusthaus owned her own home valued at $25,000 and at least $20,000 of securities. On July 31, 1940 a certificate authorizing the petitioner and his wife to carry on business under the fictitious name of "Household Furniture Co." was issued by the Commonwealth of Pennsylvania. A gift tax return for 1940 was filed by the petitioner and this reported a gift to his wife of $50,000 on January 1, 1940.

Thereafter the business proceeded in much the same fashion as prior to the partnership transaction. Petitioner, as always, managed the business. Such management was specifically provided for in the partnership agreement. The wife who had assisted in the store, or stores, prior to the partnership arrangement, continued that practice. She received no salary at any time. Prior to 1940 Mr. and Mrs. Lusthaus had maintained a joint bank account. In 1940 they opened separate accounts. There was a third account for [fol. 97] the Household Furniture Co. In 1940 the petitioner withdrew $4,604.76 from the business and the wife withdrew $59.61. In 1941 the petitioner withdrew $19,198.69 and the wife $16,317.86. The profits of the business were credited equally at the close of each year. Mrs. Lusthaus has paid three of the promissory notes. In 1940 a partnership return was filed in the name of "Household Furniture Co." showing a net profit of $80,280.20. Petitioner and his wife each reported one-half of that amount less partnership contributions, etc., in their individual returns for 1940.

On these facts the Tax Court found that the petitioner is taxable on all of the profits from the said furniture business in 1940. That Court said: "The evidence here discloses another of those superficial arrangements whereby a husband undertakes to make his wife a partner in his business for the obvious, if not the sole, purpose of reducing his income taxes."

On behalf of the petitioner it is asserted that the Tax Court erred as a matter of law in so concluding from the facts. It is urged that the facts show a legitimate, operating partnership business under general law and under the Partnership Act of the Commonwealth of Pennsylvania. Even assuming that the arrangement more or less complied

with the formalities of the Pennsylvania law, that would not necessarily be binding for tax purposes. The cases hold that the status must be genuine, with a change in economic interest. Gregory v. Helvering, 293 U. S. 465; Helvering v. Clifford, 309 U. S. 331; Higgins v. Smith, 308 U. S. 473; Griffiths v. Commissioner, 308 U. S. 355. It is well settled that taxation is a practical matter in which substance controls the form. Harrison v. Schaffner, 312 U. S. 579; United States v. Phellis, 257 U. S. 156; Weiss v. Stearn, 265 U. S. 242.

[fol. 98] The one real problem is whether there was substantial evidence to support the Tax Court's conclusion. If there was, then we are not at liberty to re-weigh the evidence or to chose between conflicting inferences. Commissioner of Internal Revenue v. The Scottish American Investment Company, Limited, — U. S. —, filed December 4, 1944; Dobson v. Commissioner, 320 U. S. 489, rehearing denied 321 U. S. 231.

It could be inferred from the evidence that there was no real contribution of capital by Mrs. Lusthaus. The circumstances surrounding the $50,000 incident, with the money immediately returned to the petitioner, could be construed as indicating that the latter had not divested himself irrevocably of the subject matter of the gift. Mrs. Lusthaus' services to the partnership were virtually the same as she had rendered in the stores prior to 1940. The testimony could be taken to indicate that the conduct of the parties with reference to the furniture company did not change. In Earp v. Jones, 131 F. 2d 292 (C. C. A. 10), certiorari denied, 318 U. S. 764, the Court said at page 294:

> "One may not merely change the form but do business in substantially the same way. An essentially new and different economic unit must be formed."

Other evidence not specifically set out in the findings of fact tends to justify the Tax Court's decision. For example, the bank with which the company had its account was not given the right to accept Mrs. Lusthaus as a partner of the concern with authority to draw checks until 1943. The petitioner continued to file social security tax returns as owner of the business through 1940 and up until June of 1941.

As the Supreme Court says in its Scottish American [fol. 99] opinion, supra, "Our examination of the record convinces us that the factual inferences and conclusions of the Tax Court are supported by substantial evidence * * *". We cannot say here that the Tax Court's conclusion to the effect that the alleged partnership was not bona fide, is unreasonable. The decision of the Tax Court is, therefore, affirmed.

DISSENTING OPINION

FAKE, District Judge, Dissenting:

This is not the first time a partnership between husband and wife has been dealt with by the Federal Courts as bearing on the payment of income taxes. If, however, there is any one sphere wherein the axiom should be followed that every case must be decided upon its own peculiar facts, it is in this complicated and elusive sphere.

A careful study of the cases cited in the briefs, together with some independent research, fails to disclose any other case wherein the pertinent evidentiary factors of the instant case are all met with. In short, nothing has been found on all fours with the problem here. While it is true that certain basic principles are spelled out in the cases and the rule requiring substantial evidence has become more or less fixed, much is yet to be desired before the lower courts can function on the subject with certainty. So also counsel, learned in the law, are placed in the same dilemma in advising their clients on the subject.

The uncontradicted evidence in this case discloses that the petitioner and his wife had given considerable thought to the question of a business partnership between them and endeavored to embark upon such a relationship. To this end petitioner retained counsel familiar with the law and [fol. 100] also a public accountant skilled in the pertinent tax problems and the necessary actuarial factors to be considered. As a result of conferences between the petitioner and his wife and in the light of the advice of the accountant and counsel, the following steps were taken to the end that a partnership might be established:

(1) The value of petitioner's business was ascertained from a statement made up from the books of the business and fixed at $230,507.62, as of January 1, 1940.

(2) On January 12, 1940, petitioner withdraw $20,000 in cash from the business, thus reducing the value of the assets to $210,507.62.

(3) On June 4, 1940, a partnership agreement was entered into between petitioner and his wife taking effect retroactively on January 1, 1940, wherein the value of the assets is fixed at $210,507.62, because of the withdrawal of 20,000 as above mentioned.

(4) On the same day, to wit, June 4, 1940, the petitioner executed and delivered to his wife a bill of sale transferring to her an undivided one-half interest of, in and to the assets of the business in consideration of the sum of $105,253.81.

(5) Petitioner made his wife a present of $50,000, evidenced by his check, to be applied by her to the purchase price above mentioned and paid a gift tax thereon.

(6) The wife gave petitioner her personal check for $50,253.81 to be applied on the purchase price, and executed and delivered to petitioner a series of eleven promissory notes each in the sum of $5,000 payable [fol. 101] in one to eleven years, respectively, thus accounting for the full purchase price, and these notes have been paid as they matured.

(7) The business is that of buying and selling household furniture, carried on in two stores, one known as Household Furniture Company and the other as Furniture Outlet Store, both in Uniontown, Pennsylvania.

(8) Certificates to transact business as partners under these assumed or fictitious names were duly filed in the Office of the Secretary of the Commonwealth and in the Office of the Prothonotary of Fayette County, pursuant to Pennsylvania law.

(9) As of January 1, 1940, partnership books were opened and thereafter the profits of the partnership were equally divided between the partners on the books of the firm, and each partner thereafter made withdrawals therefrom, making deposits in their respective individual accounts.

(10) The wife had a separate estate consisting of a dwelling valued at from $25,000 to $30,000 and secu-

rities valued at from $20,000 to $25,000 before and at the time she entered into the partnership.

(11) Before the wife entered into the partnership she had for years helped out in the stores and after the partnership she functioned in like manner.

(12) The bank with which the partnership had its account was not authorized to accept checks of the wife as a partner until 1943.

[fol. 102] (13) Social Security tax returns were filed after the partnership until 1941, reciting petitioner as owner.

(14) The income tax return for the year 1940 was filed as a partnership return.

(15) The partners instituted law suits in the partnership name.

It is upon the foregoing undisputed cold facts that the Tax Court says: "The evidence here discloses another of those superficial arrangements whereby a husband undertakes to make his wife a partner in his business for the obvious, if not the sole, purpose of reducing his income taxes."

This conclusion constitutes an omnibus generality. It indicates no specific separate evaluation of the fifteen factors involved, and bases the conclusion entirely on inference or motive rather than on the law involved. I do not understand that in all instances where one changes his financial status with relation to his wife for the purpose of reducing his income taxes, he is to have his consummated plans set at naught. The better approach would seem to be one directed to an endeavor to ascertain the legal and equitable effect of the fifteen factors with which we are here concernd.

The opinion of the Tax Court says: "Finally, the partnership emerged from the metamorphosis clothed in the outer garment of legal respectability but inwardly perhaps a little uneasy over the flimsiness of its garment of income tax alleviation." On reading this in the solitude of my chambers, surrounded by row on row of volumes dealing with the hard cold logical realities of life, it is indeed refreshing to find myself entering a mystic realm and dreaming in

unison with the poet Ovid in his Metamorphoses and imagining that dear, sweet thing, Daphne, changed into a [fol. 103] laurel while fleeing from Apollo. But I must snap out of it and reenter that mundane realm wherein a great jurist once said: "The power of tax is the power to destroy." We have here, clearly discernible, an American taxpayer, true to form, apparently inspired by his constitutional rights in the light of early American history. Surely we must respect the sacredness of his rights.

The opinion of the Tax Court holds: "The wife acquired no separate interest of her own by turning back to petitioner the $50,000 which he had given her conditionally and for that specific purpose." This, in my opinion, is a mistake of law. The uncontradicted evidence discloses that she received, under the law of Pennsylvania, a one-half interest in assets of her husband in which she theretofore had no such interest; not only is this evidenced by the articles of partnership, but also by a bill of sale, and still further pointed by the filing of certificates to transact business under assumed partnership names. While it is true that the $50,000 gift was tied to the specific use to which it was to be put, it is noted on analysis that this amounts to the same thing as a gift of an undivided interest in the assets of the business to the extent of $50,000. The assets had been valued at a sum certain. A gift tax had to be paid on that part of the consideration which was represented by the gift; hence, the check is for a sum certain to make a full disclosure and to keep the record straight for gift tax purposes. I am quite unable to find any evidence in the case from which a different conclusion can be arrived at.

The Tax Court holds: "The formalities of executing the partnership agreement and registering the business with the Pennsylvania authorities as a partnership did not [fol. 104] change petitioner's economic interests in the business." This appears to me to be a conclusion of law in direct conflict with the statutory and case law of Pennsylvania. It is arrived at arbitrarily and wholly without evidence upon which such a conclusion may be drawn. Moreover, it seems to me it is certain under the Pennsylvania law that when petitioner's wife entered the partnership, she brought with her additional capital beyond that mentioned in the partnership agreement. Her separate estate as mentioned in the tenth fact above would be liable for the firm debts on a marshalling of the assets in the event

of insolvency. This in effect strengthened the position of the petitioner and weakened that of his wife.

Under the law of Pennsylvania the petitioner and his wife as well have certainly changed their economic interest in the business. The articles of partnership and the bill of sale, emphatically and without ambiguity, accomplish very material changes. Both petitioner and his wife were solvent at the time; there is no fraud, actual or constructive; petitioner has come into court with clean hands and has made a full and complete disclosure. Therefore the articles of partnership, the bill of sale and the certificates mean exactly what they say. I must admit however that petitioner sought, among other things, a legal status which would result in a reduction of his taxes. But this he had a perfect right to do.

Thus far emphasis has been placed on the Pennsylvania law. This emphasis is occasioned by Poe v. Seaborn, 282 U. S. 101, wherein it is said, at page 110, "What, then, is the law of Washington as to ownership of community property and of community income, including the earnings of the husband's and wife's labor? The Answer is [fol. 105] found in the statutes of the State, and the decisions interpreting them."

The authority of the state in an analogous field is dealt with in Erie R. Co. v. Tompkins, 304 U. S. 64, at page 78, wherein it is said: "Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State". In this connection, it is my view, that until Congress legislates to define partnership for income tax purposes, we must of necessity resort to the state law for the purpose of ascertaining the existence of that relationship. It has its roots in the common law of the state alone, and Pennsylvania has enacted a Uniform Partnership Act in furtherance of it.

In Poe v. Seaborn, supra, an income tax problem was also before the court and it was held there that: "The District Court was right in holding that the husband and wife were entitled to file separate returns, each treating one-half of the community income as his or her respective income * * *." In 1939, the Supreme Court said in Morgan v. Commissioner, 309 U. S. 78, at page 82: "* * * in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the tax-

payer had in the property or income sought to be reached by the statute."

That there has been no falling away by the Supreme Court from the position taken in Poe v. Seaborn, supra, is apparent as late as 1942. In the case of Helvering v. Stuart, 317 U. S. 154, 161, Mr. Justice Reed says: "When Congress fixes a tax on the possibility of * * * the distribution of income, the 'necessary implication', we think, is that the possibility is to be determined by the state law."

[fol. 106] On the same day the case now before us was argued, we heard the case of Lum v. Commissioner, — F. 2d —, filed January 30, 1945. In that case we considered assignments in New Jersey made by a husband to a wife, which resulted in a tax saving by the husband. There we followed the rule in Poe v. Seaborn, supra, without directly citing it, and said: "The assignments are governed by the law of that state". It is my thought that we must follow the same rule here.

As to the substantial evidence rule which now obtains generally in administrative tribunals where the basic law so permits, and is therefore applied in this case, it is noted that a definition is provided in Edison Co. v. Labor Board, 305 U. S. 197, 229. There Mr. Chief Justice Hughes, speaking for the Court, said: "We agree that the statute, in providing that 'the findings of the Board as to the facts, if supported by evidence, shall be conclusive,' means supported by substantial evidence. * * * Substantial evidence is more than a mere scintilla. It means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." This is tied in by the Supreme Court in Dobson v. Commissioner, 320 U. S. 489, 501, as follows: "* * * all that we have said of the finality of administrative determination in other fields is applicable to determinations of the Tax Court." Again, in Commissioner v. Scottish American Co., 323 U. S. 119, 124, Mr. Justice Murphy, speaking for an unanimous court, said: "* * * when the Tax Court's factual inferences and conclusions are determinative of compliance with statutory requirements, the appellate courts are limited to a determination of whether they have *any substantial basis in the evidence.*" (Emphasis added.)

[fol. 107] A painstaking reading of the record in this case fails to disclose to my mind any evidence whatever, much

less substantial evidence as above defined, to sustain the conclusion that the petitioner received that income which the law of Pennsylvania vested in his wife. If *earned* income plays a part, it appears that the capital the wife put in was stored up labor and functioned as such in addition to her personal services. The facts set forth in (12) and (13) hereof furnish excellent examples of what Mr. Chief Justice Hughes had in mind when he referred to scintilla evidence as being insufficient to constitute substantial evidence, as quoted above. This in no way conflicts with Norton v. Warner Co., 321 U. S. 565, 568, wherein it is said: "* * * the District Court was not warranted in setting aside such an order because the court would weigh or appraise the evidence differently." Nor is it in conflict with Commissioner v. Scottish American Co., 323 U. S. 119. In identifying scintilla evidence no weighing process is involved since now by decision, the judicial stilliards cannot be adjusted to the weighing of the infinitesimal. It is now merely a matter of identification and this court is still free to identify it and call it by its right name.

In recent years an enormous corpus juris has arisen in what is termed the field of Administrative Law. In the administrative process the right to trial by jury is denied, the rules of evidence based on logic and centuries of experience in Anglo-Saxon jurisprudence are all but ignored, and in appeals, consideration of the facts de novo is prohibited. Thus we have ushered in the continental system in a vast field. The late greatly lamented Lord Chief Justice Hewart of England being concerned with such thoughts took time from the bench to write an illuminating book on [fol. 108] the subject. The title of his book sums up the whole matter as "The New Despotism". Cosmopolitan Book Corp., New York 1929. Yet, in the face of this tremendous foreign onslaught, the courts in equity still function serenely on appeals in the light of the evidence before them with full power to consider the facts de novo, and so also in non jury cases at law. Thus it is seen that in the sphere of administrative law the rights of American citizens, involving their personal liberty and their private property, are being at times manhandled without logic and without heed to the spirit of Anglo-Saxon tradition. Unless the appellate courts intelligently and courageously identify scintilla evidence and cast it out when they do find it, the

Bill of Rights, with its reservations in the States, becomes a mockery to all lovers of liberty. If in the future, perchance, the citizenry of America finds itself in the throes of tyranny, it will not be a satisfactory answer by the guardians of liberty, the courts, to say then, that the "situation did not warrant a great expenditure of appellate court energy on unraveling conflicting factual inferences" as is said in Commissioner v. Scottish American Co., supra.

There is a branch of the law of evidence to be considered which has not as yet been stricken down. The Tax Court has found as an ultimate fact that the petitioner theoretically is in receipt of an income, which on the uncontradicted evidence he never did receive. This is arrived at of course by the injection of inferences. The vice of this is that we find inferences founded on inferences. In dealing with this subject, Wigmore on Evidence, 3rd Edition, Sec. 41, approves New York Life Ins. Co. v. McNeely, — Ariz. —, 79 Pac. 2nd 948, wherein it is said: "* * * the prior inferences must be established to the exclusion of any other reasonable theory rather than merely by a probability, in [fol. 109] order that the last inference of the *probability* of the ultimate fact may be based thereon." (Emphasis added.) See also, Whealton v. U. S., 113 Fed. 2nd 710, in this Circuit, and U. S. v. Ross, 92 U. S. 281.

For the reasons aforesaid I would reverse the decision of the Tax Court.

A true Copy. Teste:

—— —— Clerk of the United States Circuit Court of Appeals for the Third Circuit.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS

[Title omitted]

And afterwards, to wit, the 7th day of December, 1944, come the parties aforesaid by their counsel aforesaid, and this case being called for argument sur pleadings and briefs, before the Honorable Herbert F. Goodrich, and Honorable Gerald McLaughlin, Circuit Judges, and Honorable Guy L. Fake, District Judge, and the Court not being fully advised in the premises, takes further time for the consideration thereof,

And afterwards, to wit, on the 11th day of April, 1945, come the parties aforesaid by their counsel aforesaid, [fol. 110] and the Court, now being fully advised in the premises, renders the following decision:

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1944

No. 8697

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Present: Goodrich and McLaughlin, Circuit Judges, and Fake, District Judge.

Appeal from the Tax Court of the United States

JUDGMENT—Filed April 11, 1945

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court of the United States in this cause be, and the same is hereby affirmed.

By the Court, Gerald McLaughlin, Circuit Judge.

April 11, 1945.

[File endorsement omitted.]

[fol. 111] IN THE UNITED STATES CIRCUIT COURT OF APPEALS

[Title omitted]

PETITION FOR REHEARING ON PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES

A. L. Lusthaus, petitioner in the above proceeding in which, following oral argument and the submission of printed briefs, your Honorable Court entered its opinion on

April 11, 1945, wherein the decision of the Tax Court of the United States was affirmed, hereby respectfully petitions your Honorable Court, pursuant to Rule 35 of the Rules of the United States Circuit Court of Appeals of the Third Circuit, that the matter be reheard. The grounds relied upon by the petitioner in support of his said petition for rehearing are as follows:

Statement of Points Relied Upon

1. The basic and fundamental premise upon which the Tax Court's decision is grounded is its *legal conclusion* that petitioner's gift of $50,000 to his wife was conditional and therefore no title or interest in the subject matter thereof vested in the wife. This is a mistake of law.

[fol. 112] 2. From such basic premise the Tax Court draws a second legal conclusion, to wit, that the payment of said $50,000 to petitioner by his wife as consideration for the bill of sale transferring to her an undivided one-half interest in his furniture business, did not vest in her any title, interest or ownership of said property. This is a mistake of law.

3. Upon the two false premises above recited the Tax Court then draws the factual conclusion that since petitioner's wife owned nothing by virtue of the gift, she acquired nothing by the bill of sale, which lacked consideration, and, consequently, she made no real contribution to the partnership and it cannot be recognized for tax purposes.

4. Decisions of the Tax Court entered subsequent to the opinion in the instant case and acquiesced in by the Commissioner of Internal Revenue have abandoned as untenable the principle of law that a conditional gift followed by prompt performance of the conditions subsequent is not a completed gift.*

---

* *R. P. Scherer v. Commissioner*, 3 T. C. 776 (acq.); *J. D. Johnston, Jr. v. Commissioner*, 3 T. C. 799 (acq.); *M. W. Smith, Jr. v. Commissioner*, 3 T. C. 894 (acq.); also Memorandum Opinion *J. W. Haliwanger*, C. C. H. Dec. 14334M, decided January 18, 1945; all giving complete recognition to the validity of a contribution made by a wife who is actually the owner of the property interest or property contributed.

5. The decision of the United States Circuit Court of Appeals for the Sixth Circuit in the case of *Francis E. Tower v. Commissioner of Internal Revenue*, decided April 2, 1945, is authority for and recognizes the principle of law that a gift *inter vivos* by a husband to his wife is nevertheless valid and complete even though coupled with the condition that the donee shall promptly invest the subject matter of such gift in a designated manner. Such gift vests com- [fol. 113] plete title in the donee, once the condition is extinguished.

6. The recent decision of this Court in the case of *Ralph E. Lum v. Commissioner of Internal Revenue*, decided January 30, 1945, 45-1 U. S. T. C., paragraph 9155, is authority for and recognizes the principle of law that the interpretation of a written document is a question of law and that, where such writing affects property interests or contract rights, it is governed by the law of the state in which the parties reside and the instrument was executed.

7. The decision of this Court in the instant case is in conflict with its decision in the case of *Ralph E. Lum v. Commissioner of Internal Revenue. supra*, as pointed out in the dissenting opinion. It is also in conflict with the decision in the case of *Francis E. Tower, supra.*

8. The decision of the Court in the instant case is erroneous in that the basic finding of the Tax Court is considered as a factual conclusion; whereas such conclusion is not a factual but is a *legal conclusion* and constitutes a clear-cut mistake of law.

Discussion

The majority opinion of the Court entered in this case is grounded upon what petitioner believes to be an erroneous conclusion of law rather than a factual conclusion based upon evidence. Petitioner respectfully submits that both the opinion of the United States Tax Court and the majority opinion entered in this case cannot find support except upon the basic premise that petitioner's wife did not acquire and own the sum of $50,000 received by her as a gift from her husband. If petitioner's wife did not own [fol. 114] the $50,000, it might be inferred that she had nothing to give and that she gave no consideration for the transfer to her of an undivided interest in her husband's

furniture business, that she made no actual contribution to the partnership. If, on the other hand, petitioner's wife *did in fact receive and in law became the owner of $50,000 by valid gift*, and if thereafter she invested her $50,000 and acquired ownership of an interest in the furniture business theretofore conducted by her husband, *the vesting in her of an income-producing asset cannot be ignored under the Pennsylvania law nor under the Federal Income Tax Law.*

Petitioner does not believe it to be the intent of your Honorable Court to hold that where a wife makes an *actual contribution of her own cash* to a business partnership in which capital is an income-producing factor, the income which is the fruit of her capital investment can arbitrarily be considered as taxable to her partner merely because that partner is her husband.

We understand, on the contrary, that the opinion of your Honorable Court is grounded upon the following conclusions accepted as factual and as supported by the evidence:

1. That petitioner's gift of $50,000 to his wife was upon condition that she invest the subject matter thereof in a proposed partnership.

This is a factual conclusion and is correct.

2. That from the presence of such condition attaching to the gift it may be inferred that petitioner retained such "control" that no change in economic interest resulted. The gift was incomplete.

This is a legal and not a factual conclusion and as such is not supported in law.

[fol. 115] 3. That the bill of sale and partnership agreement were ineffective to vest property rights in petitioner's wife since she gave no consideration for the transfer and made no real contribution to the capital of the partnership.

This is a legal and not a factual conclusion. It is reached by the application of incorrect principles of law.

4. That the conveyances to petitioner's wife were superficial and for the obvious if not for the sole purpose of reducing income tax. Consequently the alleged partnership was not bona fide.

This is the "ultimate finding" or conclusion grounded upon the preliminary premises hereinbefore recited.

Petitioner asserts that even if the above conclusions of the Tax Court were factual conclusions, there is no evidence in the record legally sufficient to support them. In this connection the Court's attention is directed to the basic principle that substantial evidence means more than a scintilla of evidence, that it means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. See *Edison Company v. Labor Board*, 305 U. S. 197. This basic test is not changed by the decision of the Supreme Court in *Dobson v. Commissioner*, 320 U. S. 489, nor in the case of *Commissioner v. Scottish American Company*, 323 U. S. 119.

Petitioner contends that in the light of the decision of the United States Circuit Court of Appeals of the Sixth Circuit in the case of *Francis E. Tower v. Commissioner of Internal Revenue*, decided April 2, 1945, the Tax Court's conclusion that no property rights vested in petitioner's wife by virtue of his gift to her is a mistake of law; and further that the Tax Court made a second mistake of law [fol. 116] when it held that the bill of sale of petitioner to his wife effected no change in the economic interests of the parties. The opinion of the Tax Court holds: "The wife acquired no separate interest of her own by turning back to petitioner the $50,000 which he had given her conditionally and for that specific purpose." This statement necessarily involves the validity and completeness of the gift in question. It is a mistake of law. It is also the basic premise upon which the Tax Court's ultimate finding is grounded.

In the *Tower* case, *supra*, which involved the gift of the capital stock of a corporation made by a husband to his wife with the understanding that upon liquidation of the corporation the wife should transfer her interest to a partnership to be formed, Circuit Judge Simons, speaking for the majority, said as follows:

> "The tax judge reasoned that the taxpayer did not relinquish control of the stock transferred to his wife since she could use it in but one way, namely, to place corporate assets, which the stock represented, into the partnership. Because of the condition attached to it, the transfer did not constitute a valid and complete gift of shares. There was no purpose and intent to vest absolute dominion over the shares in the wife,

and since she lacked untrammeled freedom in their disposition, she made no capital contribution to the partnership, and was not a bona fide partner. The conclusion that the transfer was invalid as a gift is rested on the ground that title, dominion, and control of the subject matter were not, *in praesenti*, conveyed. Reliance is chiefly placed on *Edson v. Lucas*, 40 Fed. (2d) 398 (C. C. A. 8), where essential elements of a gift *inter vivos*, are catalogued. In that case, however, [fol. 117] the conditions attached to the gift went far beyond that here involved, including reversion of the subject matter to the donor. Notwithstanding, the gift was sustained, Judge Sanborn, after an exhaustive analysis of cases, arriving at the conclusion that a gift is not invalid because of conditions imposed by the donor which are not inconsistent with the immediate vesting of such legal title in the donee. The case is authority for the validity of a gift, even though coupled with a condition subsequent which doesn't interfere with the vesting of title in the donee. Such was the gift here involved.

"Granted, however, that, because of the condition, Tower's gift was not complete at the time he gave the shares to his wife, the condition was almost immediately performed. The gift was then both valid and complete, vesting title in the wife to the corporation assets contributed by her to the partnership capital. * * *"

In the *Tower* case, *supra*, as in the instant case, the basic conclusion regarding the gift involved rests on the ground that title, dominion and control of the subject matter thereof was not conveyed. Under this decision such basic conclusion is demonstrated as a mistake of law. The corollary and supporting principle of law is that property rights or legal status determined or established pursuant to local law is entitled to recognition for Federal income tax purposes, and can be the subject of taxation only as provided in the tax statutes. See *Helvering v. Stuart*, 317 U. S. 154, 87 L. Ed. 154; *Blair v. Commissioner*, 300 U. S. 5, 9, 81 L. Ed. 465-469; *Freuler v. Helvering*, 291 U. S. 35, 78 L. Ed. 634; *Poe v. Seaborn*, 282 U. S. 101, 110; *Erie R. Co.* [fol. 118] *v. Tompkins*, 304 U. S. 64; *Morgan v. Commis-*

sioner, 309 U. S. 78; in which latter case the Court says, at page 82:

> "In the application of a Federal Revenue Act, state law controls in determining the nature of the legal interest which the taxpayer had in the property or income sought to be reached by the statute."

These principles are fully recognized in the decision of your Honorable Court in the recent case of *Lum v. Commissioner*, filed January 30, 1945, 45-1 U. S. T. C., paragraph 9155. This case involved the legal effect of an assignment of real estate. It was held that the issue involved was not a question of fact but an interpretation of the written document which the Court is free to construe for itself. The opinion states affirmatively that the real estate being located in New Jersey, "the assignments are governed by the law of that state," citing *Blair v. Commissioner, supra.* With respect to the assignment held to be a valid transfer of a property interest, the decision states that the transferee is responsible for income tax on the rent received under lease. This is equivalent to stating that the transferee, being the owner of a property right or interest established under local law, must of necessity be subject to Federal income tax only to the extent and in the manner in which the Federal Internal Revenue Acts make him taxable as the owner of property.

The Tax Court has not made any finding of fact that the gift in question was not valid. The reasoning is that the petitioner retained "control" over the subject matter of the gift by attaching the condition that it be invested in the partnership and that because of this condition subsequent the petitioner's wife owned nothing and consequently could not and did not contribute anything to or acquire a [fol. 119] "separate interest" in the partnership. The principle of law that such gift is complete upon extinguishment of the condition, and vests title in the donee is disregarded.

Petitioner therefore earnestly contends that the actual problem presented in this case was not considered or passed upon in the majority opinion. The real issue is whether or not petitioner's wife became the actual owner of property by gift and/or by a purchase. If she did in fact become the actual owner of property by gift, she admittedly con-

tributed to the capital of the partnership enterprise. Transactions which in law change property rights and economic interest and ownership are in no sense "superficial arrangements." Their reality cannot be questioned.

Wherefore, it is respectfully requested that your Honorable Court grant petitioner a rehearing and reargument in this case so that further full and adequate consideration may be given to the facts herein involved and the principles of law applicable thereto, to the end that the decision of the Tax Court be reversed as grounded upon a mistake of law.

Respectfully submitted, W. A. Seifert, William Wallace Booth, Paul E. Hutchinson.

[fol. 120] CERTIFICATE OF COUNSEL

I, Paul E. Hutchinson, of Counsel for petitioner, do hereby certify that the foregoing petition for rehearing and reargument of the above-entitled case is presented in good faith and not for the purpose of delay, but because petitioner and his counsel believe that petitioner has been unjustly aggrieved by the opinion of the Court.

Paul E. Hutchinson, of Counsel for Petitioner.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS

[Title omitted]

ORDER DENYING PETITION FOR REHEARING—Filed May 28, 1945

And now, to wit May 28th, 1945 after due consideration, the petition for rehearing in the above-entitled case is hereby denied.

Biggs, Circuit Judge.

[File endorsement omitted.]

[fol. 121] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 122] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 8, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Jackson and Mr. Justice Burton took no part in the consideration or decision of this application.

FILE COPY

Office - Supreme Court, U. S.
JUL 26 1945
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

NO. 263 TERM, 194..

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

W. A. SEIFERT,
WILLIAM WALLACE BOOTH,
NORMAN D. KELLER,
PAUL E. HUTCHINSON,
Attorneys for Petitioner.

Of Counsel:
REED, SMITH, SHAW & McCLAY,
747 Union Trust Building,
Pittsburgh, Pennsylvania.
JOSEPH W. RAY, JR.,
Fayette Title & Trust Building,
Uniontown, Pennsylvania.

SMITH BROS. CO. INC., LAW PRINTERS, 434-436 BOULEVARD OF ALLIES, PITTSBURGH, PA.

INDEX.

	PAGE
Opinions Below	1
Jurisdiction	2
Statutes and Regulations Involved	2
Questions Presented	2
Statement	3
Reasons for Granting Writ	6
Conclusion	16

APPENDIX.

Internal Revenue Code	
Section 22 (a)	17
Section 181	17
Section 182 (c)	17
Section 3797 (a) (2)	18

CASES CITED.

Bingham, Trust U/W of v. Commissioner, decided June 4, 1945	7
Blair v. Commissioner, 300 U.S. 5, 81 L. Ed. 465	8
Burnet v. Leininger, 285 U.S. 136	14
DeKorse v. Commissioner, entered May 22, 1945 (C.C.H., Dec. 14,563)	14
Dobson v. Commissioner, 320 U.S. 489	7, 12
Edson v. Lucas, 40 Fed. (2d) 398	10, 12
Erie Railroad Company v. Tompkins, 304 U.S. 67	6
Helvering v. Stuart, 317 U.S. 154, 87 L. Ed. 154	6
Helvering v. Taylor, 293 U.S. 507	9
Johnston v. Commissioner, 3 T.C. 799	14

PAGE

Lorenz, Frank J. v. Commissioner, 3 T.C. 746 (affirmed per curiam 148 Fed. (2d) 528, April 13, 1945, 6 C.C.A.) 13

Lowry, O. William v. Commissioner, 3 T.C. 730 (on appeal 6 C.C.A.) 13

Lucas v. Earl, 281 U.S. 111 14

McEachern, D. H. v. Commissioner, entered May 7, 1945, 5 T.C. .... (C.C.H. Dec. ....) 14

Morgan v. Commissioner, 309 U.S. 78 6

Munter, Carl P. v. Commissioner, entered May 16, 1945, 5 T.C. .... (C.C.H., Dec. 14,555) 14

Poe v. Seaborn, 282 U.S. 101, 75 L. Ed. 239 6

Scherer v. Commissioner, 3 T.C. 776 14

Smith v. Commissioner, 3 T.C. 894 14

Thorrez v. Commissioner, entered May 21, 1945, 5 T.C. .... (C.C.H., Dec. 14,560) 14

Tower, Francis E. v. Commissioner, 148 Fed. (2d) 388, 3 T.C. 396 ..... 9, 10, 11, 12, 14, 15

Zukaitis v. Commissioner, 3 T.C. 814 14

IN THE

Supreme Court of the United States

NO. ..... TERM, 194...

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

A. L. Lusthaus, petitioner above named, respectfully petitions your Honorable Court that a writ of certiorari issue to review the decision and order of the United States Circuit Court of Appeals for the Third Circuit entered April 11, 1945, affirming a decision of the Tax Court of the United States entered March 29, 1944, in favor of the respondent and against the petitioner.

Opinions Below.

The opinion of the Tax Court of the United States is printed at pages 86 a to 92 a of the record, and is reported at 3 T.C. 540. The opinion of the Circuit Court of Appeals is printed in the record (pages 95 a to 109 a).

It is reported in 149 Fed. (2d) 232. The dissenting opinion of District Judge Fake is also printed in the record (pages 99 a to 109 a).

Jurisdiction.

The decision of the Circuit Court of Appeals was entered April 11, 1945. A petition for rehearing was filed April 25, 1945. Rehearing was denied May 28, 1945, and an order was entered on the same date. The jurisdiction of the Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938 (Section 347 of Title 28 U.S.C.A.).

Statutes and Regulations Involved.

The statutes and regulations here involved may be found in the Appendix, *infra*, pages 17 to 18.

Questions Presented.

1. Where a husband and wife form a partnership for the conduct of a business requiring substantial capital, to which the wife makes a capital contribution of property owned by her and under local law her property and contract rights as a partner are fully recognized, can such partnership status and the individual property interests of the partners, as established by law, be entirely disregarded for income tax purposes?

2. Where a husband makes a gift of money to his wife upon condition that it be used to purchase from him an undivided interest in the assets of a furniture business owned by him and that she will thereafter con-

tribute such interest to the capital of a partnership to be formed with him for the conduct of the business and such conditions are fulfilled, can it be inferred from such facts and circumstances that no change in economic interests resulted and the wife acquired no separate property interest of her own, or do such facts evidence, as a matter of law, a valid and complete gift vesting title in the wife?

3. Is there any evidence in the record legally sufficient to warrant the Tax Court's determination that the property transfers made and the legal partnership formed between petitioner and his wife were fictitious and unreal and should be given no recognition for federal income tax purposes?

4. Is the decision of the Tax Court based on a mistake of law?

Statement.

Petitioner for many years was the owner of and operated a retail furniture business consisting of two stores, both in Uniontown, Pennsyylvania (R. 4 a). Lillian Lusthaus, his wife, had at all times prior to 1940 assisted petitioner in his stores and she continued in that practice at all times here involved (R. 41 a). She received no salary at any time. Apart from the gift of $50,000 hereinafter referred to, petitioner's wife had a separate estate valued at at least $45,000 (R. 34 a).

Petitioner and his wife agreed that petitioner should sell to her a one-half interest in his business for $105,000, effective January 1, 1940, and that they should become partners and thereafter conduct the business as a partnership (R. 5 a-7 a). The net worth of the busi-

ness as of January 1, 1940, was determined to be approximately $210,000 (R. 6 a). Petitioner made a gift to his wife of $50,000 (R. 18 a) and filed a gift tax return thereon (R. 17 a). Petitioner then executed and delivered to his wife a bill of sale for an undivided one-half interest in his furniture business for a consideration of $105,253.81 (R. 11 a). Mrs. Lusthaus gave to petitioner her personal check for $50,253.81 (R. 11 a), together with eleven promissory notes totalling $55,000, payable in one to eleven years from date, respectively, thus accounting for the full purchase price. These notes have been paid by her as they matured (R. 12 a).

The parties complied with the law of Pennsylvania in registering under the Fictitious Names Act of the Commonwealth of Pennsylvania (R. 56 a-57 a). Partnership books were opened as of January 1, 1940 (R. 10 a), and thereafter the profits of the partnership were equally divided between the partners on the books of account and each partner made withdrawals therefrom and made deposits in their respective individual accounts (R. 44 a-48 a). The income tax returns for 1940 and subsequent years were filed as partnership returns (R. 45 a). Litigation was brought in the partnership name. Through oversight (R. 29 a) the bank was not notified to honor the wife's signature on partnership checks until 1943. Continuing office practice, social security tax returns as prepared by the bookkeeper were executed by petitioner as "owner" until June of 1941 (R. 27 a). The character and extent of Mrs. Lusthaus' services in the business were not changed after the formation of the partnership (R. 41 a). The partnership was formed after consultation with accountants and counsel (R. 52 a) and the legal formalities suggested by counsel were complied with. It appears to be conceded

and is a fact that capital is a material income producing factor in the furniture business here involved. Balance sheets appear as exhibits (R. 78 a-81 a).

The decision of the Tax Court of the United States upheld the right of the Commissioner of Internal Revenue to include as a part of petitioner's gross income all of the profit of said furniture business for 1940 and affirmed his determination of an income tax deficiency of $22,419.98 for said year.

On these facts the Tax Court said as follows (R. 90 a):

> "The evidence here discloses another of those superficial arrangements whereby a husband undertakes to make his wife a partner in his business for the obvious, if not the sole, purpose of reducing his income taxes."

The Tax Court further said (R. 91 a):

> "The wife acquired no separate interest of her own by turning back to petitioner the $50,000 which he had given her conditionally and for that specific purpose."

Upon review the Circuit Court of Appeals considered such conclusions as factual conclusions which could be inferred from the evidence and which it as the reviewing court was not at liberty to reweigh and was required to accept. The majority opinion states as follows:

> "The one real problem is whether there was substantial evidence to support the Tax Court's conclusion. If there was, then we are not at liberty to reweigh the evidence or choose between conflicting inferences." (page 98 a)

The opinion further said:

"It could be inferred from the evidence that there was no real contribution of capital by Mrs. Lusthaus. The circumstances surrounding the $50,000 incident, with the money immediately returned to the petitioner, could be construed as indicating that the latter had not divested himself irrevocably of the subject matter of the gift."

On April 11, 1945, the decision of the Tax Court was affirmed by the Circuit Court of Appeals. Plaintiff's petition for a rehearing was denied on May 28, 1945.

One judge vigorously and logically dissented (R. 99 a).

Reasons for Granting the Writ.

1. The decision of the Third Circuit Court of Appeals in affirming the decision of the Tax Court of the United States conflicts in principle with applicable decisions of this Court which have announced and have adhered to the principle that in the application of a federal revenue act state law controls in determining the nature of the legal interest which a taxpayer has in the property or income sought to be reached by the statute. See *Poe v. Seaborn,* 282 U. S. 101; *Erie Railroad Company v. Tompkins,* 304 U. S. 67, at page 78; *Morgan v. Commissioner,* 309 U. S. 78, at page 82; *Helvering v. Stuart,* 317 U. S. 154, at page 161.

The decision of the Tax Court, as affirmed by the Circuit Court of Appeals, states that the "formalities" engaged in by the parties "did not change petitioner's economic interest in the business." (R. 91 a) It states further that the wife "acquired no separate interest of

her own by turning back to petitioner the $50,000 which he gave her conditionally and for that specific purpose," (R. 91 a) and concludes that whether or not the arrangements made constitute a valid partnership under the laws of Pennsylvania "we do not think it should be given recognition for income tax purposes." (R. 92 a) It is submitted that such findings evidence a clear-cut mistake of law in the failure of the Tax Court to recognize and apply the principles announced in the cases above cited.

The uncontradicted facts in the record disclose that under Pennsylvania law petitioner's wife by gift and bill of sale became the legal owner of one-half interest in the assets of a business formerly owned by her husband and in which theretofore she had had no interest or title whatsoever. Under Pennsylvania law, and under general law there was of necessity a change in the economic interests of the parties. The wife became liable for all the debts of the partnership, even to the extent of her other assets.

The Circuit Court of Appeals, in affirming the decision of the Tax Court, has decided an important question of federal law in direct conflict with the established principle announced by this Court that the existence of a relationship or of a legal interest in property as established by local law and by common law rules of property must be recognized in the application of the federal revenue act. In so doing, it has departed from the principles laid down by the Court in *Dobson v. Commissioner*, 320 U. S. 489, and *Trust U/W of Bingham v. Commissioner*, decided June 4, 1945, that a "clear-cut mistake of law" made by the Tax Court requires its reversal.

The basic error of the Circuit Court of Appeals lies in its failure to distinguish between (1) its *right to disregard* for income tax purposes the *terms of any agreement which undertakes to allocate or assign income* to a person who does not produce it or own the property of which it is the fruit, and (2) its *duty to recognize* for income tax purposes a status or *legal interest* created under local law and by common law rules of property.

Conceding the fact that the partnership business in this case is such that capital is a material income producing factor and that petitioner's wife was the legal owner of a partnership interest, it follows as a necessary legal conclusion that *complete* disregard of her property rights as a partner is also in direct conflict with the applicable decision of this Court in *Blair v. Commissioner*, 300 U.S. 5, 81 L. Ed. 465. It is possible that the Tax Court on the facts of a given case would be justified in finding a *partial assignment* of income reflected in the terms of a partnership agreement making profit distribution among the legal partners, but *complete disregard of the legal property interests of the partners and the arbitrary allocation of all income to one partner is a clear abandonment of the fundamental principles of law announced by this Court.* Such a decision is "not in accordance with law."

It is respectfully submitted that the Circuit Court of Appeals, without doing violence to applicable decisions of this Court, cannot arbitrarily allocate to the petitioner for income tax purposes *that portion of the partnership income* which was produced by and resulted from the capital investment of his wife. Common law

rules of property and the applicable decisions of this Court preclude such a decision.

If the petitioner's wife was the owner of an interest in partnership property contributing to partnership income, the determination of the Commissioner allocating *all* of such income to the petitioner and declaring a deficiency in tax is in error under the principles announced in *Helvering v. Taylor,* 293 U.S. 507, in that such decision is without rational foundation and is necessarily excessive.

2. The decision of the Third Circuit Court of Appeals affirming the decision of the Tax Court is in direct conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Francis E. Tower v. Commissioner,* 148 Fed. (2d) 388, decided April 2, 1945 (3 T.C. 396).

The taxpayer in that case made a gift of corporate shares to his wife upon the understanding that the corporation would be dissolved and that she would thus be able to contribute to the capital of a new partnership to be formed with him for the further conduct of the business. The Tax Court sustained the Commissioner in the inclusion in taxpayer's income of all amounts of the partnership earnings withdrawn by or credited to the wife. This decision was based upon the theory that the taxpayer did not relinquish control of the stock transferred since it was transferred subject to the condition that the assets which it represented should constitute her contribution to a partnership to be formed. It was held that because of the condition attached to it the transfer did not constitute a valid and complete gift and hence no contribution to partnership capital was made.

The Circuit Court of Appeals, in reversing the Tax Court and remanding the case for further proceedings, cites *Edson v. Lucas,* 40 Fed. (2d) 398, and holds as follows:

> "Granted, however, that because of the condition, Tower's gift was not complete at the time he gave the shares to his wife, the condition was almost immediately performed. The gift was then both valid and complete, vesting title in the wife to the corporation assets contributed by her to the partnership capital."

In the *Tower* case the Court accepted as a necessary conclusion of law the sufficiency of the gift made by the husband and the actuality of the contribution made by the wife to the partnership capital and, with that basic and otherwise controlling premise, examined the evidence to see whether or not it contained "other facts" sufficient in law to justify the finding that the presumptively valid gift of corporate shares and the capital contribution to the partnership were unreal and a mere artifice. Reviewing the testimony, the Court determined that there was no evidence in the record upon which to base such a conclusion and cited the established principle that factual determinations must be supported by evidence and that administrative decisions must have "warrant in the record."

In the instant case it is quite clear that the Circuit Court approached its review of the Tax Court's decision upon a totally different and conflicting theory of the applicable law. The opinion of the Circuit Court of Appeals expressly states that "the one real problem is whether there was substantial evidence to support the Tax Court's conclusion" (page 98 a) and further that it

"could be inferred that there was no real contribution of capital by Mrs. Lusthaus" (page 98 a) and that "the circumstances surrounding the $50,000 incident * * * could be construed" as indicating that the petitioner had not divested himself irrevocably of the subject matter of the gift (page 98 a).

It is implicit in the language of the decision that the Circuit Court of Appeals in the instant case accepted and adopted the reasoning of the Tax Court that *the condition* attached to the gift made by petitioner to his wife *was a circumstance which could be considered as justifying its factual conclusion that petitioner had not irrevocably divested himself of the subject matter of the gift and that no change in economic interest resulted by reason thereof.* It seems quite clear from the opinion that it is based almost in its entirety upon the premise that petitioner's wife made no real contribution of capital *because the gift of $50,000 made to her upon condition,* did not vest in her the title thereto and the ownership thereof. Aside from the alleged incompleteness of the gift made by petitioner to his wife, neither the Tax Court's opinion nor the opinion of the Circuit Court of Appeals points to any evidence which under the approved standards would be legally sufficient to justify the finding that the gift in question and the partnership in question were not bona fide or were a mere sham.

These two decisions are factually similar in that each involves what in substance is the gift of a partnership interest by a husband to a wife. In the *Tower* case there is involved the preliminary gift of corporate stock upon agreement that following dissolution the corporate assets will become partnership capital; whereas in the instant case there is the gift of cash upon the agreement

that the cash will be used to purchase assets of a business which in turn shall constitute capital of a partnership to be formed.

The basic issue involved in both of these cases is whether in an income tax case the circumstances surrounding a gift by a husband to his wife and the acquisition by her of a partnership interest in his business raise *questions of fact* from which artifice, sham and *mala fides* can be inferred or whether the *legal consequences of what was done* by the parties under general and local law must be accepted as establishing their legal rights, titles and interest and their legal liabilities. The federal law must be applied accordingly.

The Sixth Circuit Court of Appeals in the *Tower* case, *supra,* says, in effect, we accept the vesting of a legal property interest as a matter of law and in the "other evidence" find no artifice or sham.

The Third Circuit Court of Appeals in the instant case says, in effect, one *could infer from the fact that a condition was attached* to the gift, that it lacked reality, passed no legal interest and was insufficient to divest the donor of control of the subject matter; the Tax Court has so found as a fact and we are not at liberty to reweigh the evidence, citing *Dobson v. Commissioner,* 320 U.S. 489.

The Third Circuit Court of Appeals in the instant case has arbitrarily substituted for a necessary legal conclusion a faetual conclusion directly at variance therewith, a "clear-cut mistake of law."

3. The whole problem of family partnerships is of the greatest importance at this time. The public has

been assured that tax liability may properly be minimized by rearrangement of one's business affairs to that end and that the legal and actual owner of income producing property is entitled to the "fruit" it produces and is taxable thereon.

Literally thousands of taxpayers have readjusted their property interests and business methods in reliance upon these fundamental principles of law. The Commissioner of Internal Revenue, upon the apparent theory that blanket condemnation of a family partnership is a substitute for scrutiny and analysis, has, almost uniformly, refused to recognize such partnerships for income tax purposes. The result has been numerous appeals to the Tax Court of the United States and a flood of Tax Court decisions based upon a miscellany of conflicting theories that spell complete confusion and chaos. No standard of measurement has been given to the taxpayer except the unpredictable agreement or disagreement of the Court as a factual determination, that a transaction should or should not be given tax effect.

Since the decision of the Tax Court in the instant case it has rendered numerous decisions in which the circumstances surrounding the making of gifts to a wife have been considered as determinative of the validity of a family partnership. Following two decisions favorable to the Commissioner on the theory that the gifts were incomplete[1], four published decisions were entered

---

[1] *O. William Lowry v. Commissioner*, 3 T.C. 730 (on appeal 6 C.C.A.), and *F. J. Lorenz v. Commissioner*, 3 T.C. 746 (affirmed per curiam 148 Fed. (2d) 528, April 13, 1945, 6 C.C.A.).

recognizing the validity of gifts and were acquiesced in by the Commissioner.[2] In all these cases capital was an income producing factor.

At this point it appeared that some pattern was being adopted for the guidance of the taxpayer, and this belief was confirmed when on April 2, 1945, the Circuit Court of Appeals of the Sixth Circuit reversed the Tax Court's decision in the *Tower* case, *supra*. However, on April 11, 1945, the decision in the instant case was handed down, in direct conflict with the decision in the *Tower* case, and the whole issue was again in confusion.

Further confusion has resulted from more recent decisions[3] of the Tax Court involving the same issue and which, supporting the Commissioner's contentions, appear to overrule its prior decisions. In nearly every instance dissenting opinions were filed or dissents registered. Some of these more recent decisions reject the gift theory and rely upon the "equitable assignment" of income principles announced by this Court in *Lucas v. Earl*, 281 U.S. 111, and *Burnet v. Leininger*, 285 U.S. 136.

In other decisions of The Tax Court of the United States the principles urged in the instant case were given recognition.[4] In the *Thorrez* decision[3] there were

---

[2] *Sherrer v. Commissioner*, 3 T.C. 776; *Johnson v. Commissioner*, 3 T.C. 799; *Smith v. Commissioner*, 3 T.C. 894; *Zukaitis v. Commissioner*, 3 T.C. 814.

[3] *Thorrez v. Commissioner*, entered May 21, 1945, 5 T.C. . . . (C.C.H., Dec. 14560); *DeKorse v. Commissioner*, entered May 22, 1945 (C.C.H., Dec. 14563); *Carl P. Munter v. Commissioner*, entered May 16, 1945, 5 T.C. . . . . (C.C.H., Dec. 14555).

[4] *D. H. McEachern v. Commissioner*, entered May 7, 1945, 5 T.C. . . . . (C.C.H., Dec. . . . .).

six dissents, with three separate dissenting opinions. In a concurring opinion Judge Mellot states that the result of the efforts of the various Circuit Courts of Appeals and The Tax Court to find the "correct rule," in the absence of any pronouncement by the Supreme Court upon the subject "has not been entirely satisfactory." His opinion is entered in the hope of "dispelling the fog of uncertainty."

In the instant case the vigorous dissent of District Judge Fake not only states very well the principles of law properly applicable in family partnership cases, but also points out the importance to taxpayers generally of establishing some definite standards for measuring the validity and effect of a gift by a husband to his wife of a property interest in his business and its assets.

It is important in the administration of the revenue acts, both to the Treasury Department and to the taxpaying citizens, that the conflict herein discussed should be clarified and that some degree of uniformity in treatment of this type of case should be adopted. Petitioner believes that the matter here presented is one of public interest and importance affecting the conduct of business throughout the United States. The wide publicity and comment which this subject of family partnerships and which the instant decision, as apparently in conflict with the decision in the *Tower* case, *supra,* has had in legal, tax and business periodicals* will attest its public interest and importance.

** American Bar Association Journal,* "Family Partnerships," page 322, June, 1945.

Commerce Clearing House 1945 Rewrite Bulletin, No. 27, paragraph 8414, May 9, 1945.

Ibid., No. 28, paragraph 8420, June 27, 1945.

Conclusion.

For the foregoing reasons it is respectfully submitted that this petition should be granted and that writ of certiorari should issue to the Circuit Court of Appeals for the Third Circuit.

Respectfully submitted,

W. A. SEIFERT,
WILLIAM WALLACE BOOTH,
NORMAN D. KELLER,
PAUL E. HUTCHINSON,
Attorneys for Petitioner.

Of Counsel:
REED, SMITH, SHAW & MCCLAY,
747 Union Trust Building,
Pittsburgh, Pennsylvania.

JOSEPH W. RAY, JR.,
Fayette Title & Trust Building,
Uniontown, Pennsylvania.

Estate and Tax News, Reprint of "That Family Partnership Quarrel," page 552, June, 1945 (material copyright Prentice Hall, Inc.).

George Washington Law Review, "The Partnership in Tax Avoidance," by Randolph Paul, page ...., February, 1945, condensed digest in *Taxes*, page 552, June, 1945.

Prentice Hall, *Current Commentary Report*, No. 23, paragraph 70526.

APPENDIX.

Statutes Involved.

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political sub-division thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 1940 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). (26 U. S. C. 1940 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. (26 U. S. C. 1940 ed., Sec. 3797.)

FILE COPY

Office - Supreme Court, U. S.
DEC 7 1945
CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States

OCTOBER TERM, 1945.

NO. 263.

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF ON BEHALF OF PETITIONER.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

W. A. SEIFERT,
WILLIAM WALLACE BOOTH,
NORMAN D. KELLER,
PAUL E. HUTCHINSON,
Attorneys for Petitioner.

Of Counsel:
REED, SMITH, SHAW & McCLAY,
747 Union Trust Building,
Pittsburgh, Pa.
JOSEPH W. RAY,
Fayette Title & Trust Building,
Uniontown, Pa.

SMITH BROS. CO. INC., KAW PRINTERS, 434-436 BOULEVARD OF ALLIES, PITTSBURGH, PA.

INDEX.

	PAGE
Opinion of the Court Below	1
Jurisdictional Grounds	2
Statutes and Regulations Involved	2
Statement of the Case	2
Summary of Argument	9
Argument:	
1. If the asserted partnership is bona fide, Petitioner is taxable only upon his distributive share of partnership profits	12
2. Petitioner and his wife formed a partnership valid under local law and separate property rights were established thereby	13
3. Local law controls in determining a status or relationship made expressly subject to Federal taxation	16
4. The terms of the agreement and the acts of the parties evidence good faith and Petitioner's lack of control over the property and income of his wife	18
5. The gift to Petitioner's wife was complete and she made an actual contribution to partnership capital	27
6. The separate economic interests created by the transactions involved must be recognized for income tax purposes	29
7. An assignment of income is not involved in this case	33

PAGE

8. The Tax Court's decision is "not in accordance with law", and the decision of the Circuit Court affirming it should be reversed . . 39

9. Conclusion 44

Appendix:

Internal Revenue Code, Section 22(a), 26 U.S.C. Sec. 22 46

Internal Revenue Code, Sections 181, 182(c), 26 U.S.C. Sec. 181-182 46

Internal Revenue Code, Section 3797, 26 U.S.C. Sec. 3797 47

TABLE OF CASES CITED.

Beaumont v. Beaumont, 152 Fed. 55 28
Blair v. Commissioner, 300 U.S. 5 . . . . . 17, 34
Burnet v. Leininger, 285 U.S. 136 . . . . . 34, 37
Commissioner v. Branch, 114 F. (2d) 985 20
Commissioner v. Katz, 139 F. (2d) 107 20
Commissioner v. Scottish American Co., 323 U.S. 119, 124 . . . . . 23, 42
Dobson v. Commissioner, 320 U.S. 49 . . . . . 39, 42
Edison Co. v. Labor Board, 305 U.S. 197, 229 42
Edson v. Lucas, 40 F. (2d) 398 28
Gregory v. Helvering, 293 U.S. 465 30
Helvering v. Clifford, 309 U.S. 331 . . . . . 29, 30, 32
Helvering v. Eubank, 311 U.S. 122 34
Helvering v. Fuller, 310 U.S. 69, 74 17
Helvering v. Horst, 311 U.S. 112 34
Helvering v. Stuart, 317 U.S. 154, 161 17

PAGE

Helvering v. Taylor, 293 U.S. 507 38
Jones v. Norris, 122 F. (2d) 6 20
Lucas v. Earl, 281 U.S. 111 34
Meehan v. Valentine, 145 U.S. 611 14
Morgan v. Commissioner, 309 U.S. 78, 82 17
Northampton Brewery Corp. v. Laude, 138 Pa. Super. 235 13
Pearch v. Commissioner, 315 U.S. 543 34
Poe v. Seaborn, 282 U.S. 101, 110 17
Rowland v. Canuso, 329 Pa. 72, 79 25
Schuster v. Largman et al., 308 Pa. 520, 528 14
Trust u/w Mary Lily (Flager) Bingham et al. v. Commissioner, ... U.S. ...., 89 L. ed. (advance opinions) 1191 ..... 40, 41

STATUTES CITED.

Act of Assembly of Commonwealth of Pennsylvania, 1917 P. L. 645d, as amended 54 P.S. 21 25-26
Revenue Act of 1937, 59 Stat. 813-26, U.S.C. 973 31-32
The Uniform Partnership Act, 1915 P. L. as amended, P.S. Title 59, Secs. 11-13-37-51-71-72-73 14-16
Internal Revenue Code, Secs. 181-182(c), 26 U.S.C. (1940), Secs. 181-182 ..... 9, 13, 20, 33

OTHER CITATIONS.

C.J.S. Vol. 38 Gifts, Sec. 36 28
Report of the Joint Committee of Tax Evasion and Avoidance—75th Congress, First Session, House Document No. 337 31

Supreme Court of the United States

OCTOBER TERM, 1945.

NO. 263.

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF ON BEHALF OF PETITIONER.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

OPINION OF THE COURT BELOW.

The opinion of the United States Circuit Court of Appeals for the Third Circuit is reported in 149 F. 2d, 232 and appears in the record at R. 68-71. The opinion as reported and as printed in the record includes the dissenting opinion of District Judge Fake. (R. 71-78).

The opinion of the Tax Court of the United States is reported in 3 T. C. 540 and appears in the record at R. 62-66.

JURISDICTIONAL GROUNDS.

The decision of the Circuit Court of Appeals was entered on April 11, 1945. A petition for rehearing was filed April 25, 1945. An order denying rehearing was entered May 28, 1945. A petition for Writ of Certiorari was thereafter filed on July 26, 1945 and said petition was granted by your Honorable Court October 8, 1945. Jurisdiction of the Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938 U.S.C.A. Title 28, Section 347.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations herein involved may be found in the Appendix, *infra*, at pages 46 to 47.

STATEMENT OF CASE.

This case comes into this Court on writ of certiorari to the Circuit Court of Appeals for the Third Circuit to review the decision and order of said court affirming a decision of the Tax Court of the United States. The Tax Court, on petition for re-determination of a proposed deficiency, approved the respondent's determination that no bona fide partnership existed between petitioner and his wife in 1940 and held that all the profits of the business were taxable to petitioner as his individual earnings (R. 62).

The record shows that petitioner, A. L. Lusthaus was married to Lillian C. Lusthaus in 1915 (R. 24a). Petitioner started in the furniture business at Uniontown, Pennsylvania in 1918 (R. 3) and in 1933 he com-

menced the operation of a retail furniture business known as "Household Furniture Company," originally with one store and later with a second store known as "Furniture Outlet" (R. 6). The business was operated as a sole proprietorship. In all years prior to 1940, petitioner's wife worked with her husband in the business, waited on trade, took cash and helped in whatever way she was needed (R. 25). This work was done without compensation (R. 25).

In June or July of 1939, petitioner consulted his attorney (R. 38) in regard to taking in his wife as a partner in his furniture business. Concurrently, he discussed the matter with his wife, Lillian C. Lusthaus (R. 25). It was agreed that petitioner would sell a one-half interest in the business to his wife and that a partnership agreement would be entered into by them as of January 1, 1940. As originally discussed, the partnership was to be effective as of July 1, 1939 and an agreement, similar to the one later executed by the parties, was prepared by the attorney (R. 38) but it was not executed or put into effect at that time on advice of the attorney and the accountant for the business that the change should be made as of January 1, 1940 (R. 39).

An outright gift to his wife of a one-half interest in the business was also discussed but, upon the attorney's advice, this plan was not carried out and it was decided that petitioner should make a gift of $50,000 to his wife and that she should buy the one-half interest, paying for it with the $50,000, the subject of the gift, and promissory notes to total the agreed consideration (R. 39).

It was agreed that petitioner should determine the book value of his business as of January 1, 1940 and sell his wife a one-half interest therein for an amount which

represented one-half of the book value of the physical assets and inventory as of that date, excluding good will and excluding $20,000 accumulated profits to be withdrawn by petitioner (R. 4).

Petitioner and his wife agreed to proceed on this basis and the attorney was instructed in the Fall of 1939 to prepare the necessary papers which were to become effective as of January 1, 1940. (R. 4). The actual preparation of these papers was delayed by reason of the illness of the attorney from December of 1939 through January of 1940 and thereafter by his absence in Mexico and was further delayed by the departure of petitioner and his wife for Florida a few days after the attorney's return to Uniontown (R. 40).

On January 1, 1940, the business was put on a partnership basis, thereafter conducted as such (R. 41). Partnership books were opened (R. 33, 34). Thereafter, the profits of the partnership were equally divided between the partners on the books of the firm. Individual capital investment accounts were set up for each partner (R. 34) and were thereafter maintained. There was reflected in these accounts each partner's share of profits and all withdrawals made by each of them. Litigation was conducted in the partnership name (R. 42). Dun & Bradstreet were notified concerning the partnership either during 1940 or in January, 1941 (R. 17).

The value of petitioner's business as of December 31, 1939 was ascertained from a statement made up by the accountants from the books of the business to be the sum of $230,507.62 (R. 33), without giving effect to the withdrawal of $20,000 by the petitioner (Exhibit 4, R. 55, 56).

On January 12, 1940, petitioner made a withdrawal of $20,000 in cash from the business thus reducing the

value of the business assets to $210,507.62 (Exhibit 4, R. 56).

From and after January 1, 1940, petitioner continued in general charge of the operation of the partnership business. His wife continued to do some work in the store as she had done in the past (R. 31). Both of them were away from the business for about six weeks during March and April, 1940. (R. 5).

On June 4, 1940, petitioner, as agreed, executed and delivered to his wife the bill of sale (Exhibit 4, R. 53, 54, 55), transferring to her an undivided one-half interest in the assets of the furniture business owned by him prior to January 1, 1940, the transfer of ownership to be effective as of January 1, 1940. The consideration recited was the sum of $105,253.81 or one-half of the value of the business assets.

On the same date, petitioner and his wife, as agreed, executed and acknowledged the partnership agreement (Exhibit 1, R. 48, 52), to take effect retroactively on January 1, 1940 (R. 48), wherein the value of the partnership assets is fixed at $210,507.62 and the contribution of each party to partnership capital is fixed at "one-half thereof" (R. 49).

On or about the same date, petitioner made an outright gift to his wife of $50,000 by his personal check (R. 4). Petitioner raised this amount of money in part by a loan of $20,000 from the Second National Bank of Uniontown (R. 13, 14) and in part from his personal funds, including the $20,000 which he had withdrawn from his business on January 12, 1940 (R. 14).

Petitioner filed a gift tax return for 1940 (R. 13), reporting thereon a gift to his wife as of January 1, 1940 of property of the value of $50,000 (R. 34).

On June 18, 1940, petitioner's wife gave petitioner her personal check for $50,253.81 (R. 8) on account of the purchase price of a one-half interest in his furniture business and, at the same time, she executed and delivered to petitioner a series of eleven promissory notes, each in the sum of $5,000 payable in one to eleven years, respectively (R. 9), to cover the unpaid balance.

As of the date of trial, the notes maturing in January, 1941, 1942 and 1943, together with the interest accruing thereon (R. 9) had been paid in full.

As of January 1, 1940 and June 4, 1940, petitioner's wife had a separate estate consisting of a dwelling valued at from $25,000 to $30,000 and securities valued at from $20,000 to $25,000 (R. 26). Petitioner's wife for a long time prior to the partnership had maintained a personal bank account in her own name (R. 26).

During 1940, the capital account of Lillian C. Lusthaus was charged with her withdrawals amounting to the sum of $59.61 and during 1941, the sum of $16,317.86. Petitioner's capital investment account was charged during 1940 with withdrawals amounting to $4,604.76 and during 1941 with the sum of $19,198.69 (Exhibit 16, R. 60, 61).

An application for registration, stating that petitioner and his wife were engaged in business under a fictitious name, was executed and sworn to by them and was filed with the Secretary of the Commonwealth of Pennsylvania and with the Prothonotary of the Court of Common Pleas of Fayette County in 1940 (R. 42). Certificates of Registration, authorizing the parties to operate under the fictitious name of "Household Furniture Company," were thereafter issued dated July 31, 1940. Similar certificates were issued to cover the store known as "Furniture Outlet Store" (R. 42, 43).

The partnership bank account was maintained in the Second National Bank, Uniontown, Pennsylvania (R. 19) under the name "Household Furniture Company." Prior to 1940, petitioner and his wife had maintained a joint bank account. Beginning with 1940, they opened separate accounts (R. 18). Petitioner neglected to authorize the bank to honor his wife's signature on checks against the partnership account until some time in 1943 (R. 19). It was not considered necessary that the bank have her signature since petitioner had full charge of the business and she was not called upon to sign any checks (R. 22).

Social security tax returns, prepared by the bookkeeper and submitted to the petitioner for signature (R. 23), were signed by the petitioner until 1941 as "owner" instead of "partner" (R. 20, 21). The designation was typed on by the bookkeeper (R. 21) who had full charge of the work (R. 20).

The income tax return of the business for the year 1940 was filed (R. 6) as a Partnership Return of Income (Form 1065) showing petitioner and his wife as the partners and one-half of the net profits of the business distributable to each of them (Exhibit 3, R. 52a-b).

Petitioner and his wife each filed an Individual Income and Defense Tax Return for the year 1940 (Form 1040) (R. 27) and included therein as received from the partnership one-half of the net income of the partnership business as shown on said partnership return.

The respondent, in examination of petitioner's income tax return for 1940 determined an income tax deficiency in the sum of $22,419.98, the principal and contested portion of which deficiency results from the inclusion in petitioner's gross income of all the profits of said business (R. 62). The respondent determined in

his deficiency notice that no bona fide partnership existed between petitioner and his wife in 1940 (R. 64).

The Tax Court, upon the pleadings and after hearing at Pittsburgh, Pennsylvania, September 20, 1943, affirmed the determination of the respondent. The court held that, in effect, the alleged partnership was not bona fide and said (R. 65):

> "The evidence here discloses another of those superficial arrangements whereby a husband undertakes to make his wife a partner in his business for the obvious, if not the sole, purpose of reducing his income taxes."

The decision of the Tax Court was appealed to the United States Circuit Court of Appeals for the Third Circuit and the said court, following argument and briefs, entered its opinion on April 11, 1945 (R. 68, 69 and 70) affirming the decision of the Tax Court. District Judge Fake, specially assigned to sit in the said case, filed a dissenting opinion (R. 71 to 78, inclusive). Judgment was entered on April 11, 1945.

Thereafter, petitioner filed a petition for rehearing in the Circuit Court of Appeals for the Third Circuit (R. 79-86). On May 28, 1945, said petition for rehearing was denied.

Thereafter, on July 26, 1945, petitioner filed in this court his petition for writ of certiorari to review the decision of the Circuit Court of Appeals and on October 28, 1945 an order was entered granting the writ.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred;

(1) in holding that the conclusions and the decision of The Tax Court of the United States were supported by substantial evidence,

(2) in failing to hold that the decision of The Tax Court was not in accordance with law,

(3) in affirming the decision of The Tax Court.

SUMMARY OF ARGUMENT.

The sole issue in this case is whether or not the partnership formed by Petitioner and his wife is bona fide. If the asserted partnership is bona fide, the partners are liable for income tax only in their individual capacity and each partner is required to return only his distributive share of the ordinary net income of the business. Sections 181 and 182 of the Internal Revenue Code (Appendix, Pages 46-47). These sections of the Code are controlling and are determinative of Petitioner's tax liability, unless it appear that

1. The action of the Petitioner and his wife in the formation of their partnership was fictitious and fraudulent in that they did not intend to be bound by the legal effect of their actions; or

2. The Petitioner in the alleged gift and sale of a partnership interest to his wife or in the conduct of the business under the partnership agreement retained such control and dominion that there was no substantial change in his economic interests in and control of the said business and its assets.

Petitioner and his wife formed a partnership for the conduct of a business in which capital was a material income producing factor, which was valid under local law. Certain well-defined individual property rights and liabilities were thereby created. Petitioner and his wife became the co-owners of the partnership business and of the specific partnership property holding as tenants in partnership. Each of them became jointly liable for all debts and obligations of the business. Their status and the property rights vested in each of them under local

law must be given recognition for income tax purposes, if they are actual and bona fide.

There are no facts in the record to justify the Tax Court's conclusion, that the partnership was not bona fide. The terms of the partnership agreement evidence good faith and reserve to the Petitioner no control or dominion over the property or income of his wife. The transactions entered into between the parties evidence good faith and there is no evidence in the record to justify the conclusion that Petitioner failed to vest in his wife all of the incidents and attributes of ownership of the business interest which he sold to her. The gift of cash made by Petitioner to his wife was upon a condition subsequent immediately performed which was not inconsistent with the vesting of full title and control in her. By use of the subject matter of her gift and by valid notes Petitioner's wife acquired the unrestricted and complete ownership of a one-half interest in his furniture business. This business interest the wife then contributed to the capital of the partnership which she immediately formed with her husband.

There is nothing in the evidence to justify the conclusion or finding that Petitioner's wife did not acquire a separate interest of her own or that Petitioner did not through the said gift and sale and agreement change his economic interests in the furniture business which he had theretofore individually owned.

If Petitioner's wife made an actual contribution to a partnership in which capital is essential in producing partnership profits and if Petitioner and his wife became associated to carry on the partnership business as co-owners, the issue presented by this case must be resolved

in Petitioner's favor. Respondent has determined that no partnership existed and that the asserted partnership was not bona fide and would not be recognized for income tax purposes. Upon a showing that a valid bona fide partnership did exist Petitioner has demonstrated that Respondent's determination is wrong and this is the sole burden imposed upon him by the law. A potential assignment of income as distinguished from the ownership of the corpus which produces income is not involved in this proceeding.

A partnership between a husband and wife gives rise to no presumption of fraud or bad faith. It is not the province of the Tax Court to undertake a revision or change of the taxing statutes. The separate economic interest of the Petitioner and of his wife are entitled to full recognition for income tax purposes.

The Tax Court's decision is not in accordance with law, its ultimate conclusion is a clear cut mistake of law and in any event, is wholly unsupported by any substantial evidence in the record. The issues presented do not come within the special competence of the Tax Court and are subject to review on appeal. The decision of the Circuit Court, affirming the Tax Court, should be reversed.

ARGUMENT.

I. If the Asserted Partnership Is Bona Fide, Petitioner Is Taxable Only on His Distributive Share of Partnership Profits.

The question presented in this case as stated in the opinion of the court below is "whether the asserted partnership of the taxpayer and his wife should be recognized for income tax purposes" (R. 68).

The specific issue involved is the bona fides character of certain property transfers and of certain contracts entered into between petitioner and his wife and of the conduct of the partnership business created thereby (R. 17). Did petitioner's wife make an actual contribution of capital to the partnership?

The facts are not in dispute. If the transactions in question were entered into and carried through legally and in good faith, their legal effect must prevail unless it appears that the substantial attributes of ownership are retained by petitioner. There is no provision in the Federal statutes and there is no principle of law under which complete and unrestricted ownership of property or a bona fide partnership status valid under local law can be ignored for income tax purposes.

Petitioner contends that he and his wife formed a valid partnership and, under the laws of the Commonwealth of Pennsylvania, each became the owner of a one-half interest in the business, including its assets. Their separate legal property interests and contract rights are defined by law. The business engaged in was one in which capital was the material income producing factor and, upon formation of the partnership, it con-

tinued to be operated and to function as a partnership business. Each partner owned a one-half interest in the business and its assets and each was was entitled to one-half of the profits of the business.

Under these circumstances the measure of each partner's individual liability for income tax on partnership profits is fixed by the provisions of the Internal Revenue Code, Sections 181 and 182 (Appendix pp. 46-47). These provisions of the Internal Revenue Code are controlling unless there is substantial evidence in the record to show:

1. That the petitioner and his wife acted in bad faith without actual intention of being bound by the legal effect of their actions and that their arrangements and transactions amount to fraud, actual or constructive, or

2. That petitioner, in the alleged gift and sale to his wife or in the conduct of the business under the partnership agreement, retained such dominion and control of the property contributed by his wife, that there was no substantial change in his economic interests in and ownership of the said business and its assets.

II. Petitioner and His Wife Formed a Partnership Valid Under Local Law and Separate Property Rights Were Established Thereby.

It is apparently conceded that, under Pennsylvania law, a husband and wife may become business partners. (See *Northampton Brewery Corp. v. Laude*, 138 Pa. Sup. 235). The personal relationship of partners is of no consequence if their association is bona fide and an

actual contribution of capital or of services is made. Furthermore, the source of the contributions of capital which individual partners make to the capital of the firm is of no consequence if they, in fact, acquire and become the owners of actual partnership interests. In *Schuster v. Largman et al.*, 308 Pa. 520, 528, 164 Atl. 305, the Supreme Court of Pennsylvania said as follows:

> "The indispensable requisites of a partnership are co-ownership of a business and the sharing of its profits. * * * *The fundamental requisite of a partnership is co-ownership of a business.* * * * (Italics supplied)."

In *Meehan v. Valentine*, 145 U.S. 611, this court stated as follows:

> "The requisites of a partnership are that the parties must have joined together to carry on a trade or adventure for their common benefit, each contributing property or services, and having a community interest in the profits. *Ward v. Thompson*, 63 U.S. 22."

The evidentiary facts in this case, as found in the Tax Court, are not in dispute and it is apparently conceded that the partnership formed by the parties was a valid one in so far as the laws of the Commonwealth of Pennsylvania are concerned. It follows that the rights and liabilities attaching under Pennsylvania law came into being upon the formation of the partnership and affected the property and economic interest of petitioner and his wife accordingly.

The Uniform Partnership Act of Pennsylvania 1915, P.L. 18, as amended, P.S. Title 59 provides in part as follows:

"§11. *Partnership defined*

"(1) A partnership is an association of two or more persons to carry on as co-owners a business for profit."

"§13. *Partnership property*

"(1) All property originally brought into the partnership stock or subsequently acquired by purchase or otherwise, on account of the partnership, is partnership property."

Those parties who become members of a partnership, i.e., who become "co-owners" of a business, acquire a well defined legal status the incidents of which are those as established by law and by their agreement.

"§71. *Extent of property rights of partners*

The property rights of a partner are

"(1) His rights in specific partnership property.

"(2) His interest in the partnership, and

"(3) His right to participate in the management."

"§72. *Nature of partner's rights in specific partnership property*

"(1) A partner is co-owner with his partner of specific partnership property holding as a tenant in partnership."

"§73. *Nature of partner's interest in partnership*

"(1) A partner's interest in the partnership is his share of the profits and surplus and the same is partnership property."

"§37. *Nature of partner's liability*

"All partners are liable—

"(a) jointly and severally, for everything chargeable to the partnership under Sections 13 and 14*;

"(b) jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract."

It is self evident that under Pennsylvania law the petitioner and his wife as well, changed their economic interests in the business and its assets. New and different liabilities were assumed by each. Additional capital was made liable for the firm's debts since before entering into the partnership, and apart from the gift of $50,000 involved, petitioner's wife (R. 26) had a separate estate consisting of a dwelling house valued at $25,000 to $30,000 and of securities valued at from $20,000 to $25,000.

III. Local Law Controls In Determining a Status or Relationship Made Expressly Subject to Federal Taxation.

We have heretofore pointed out that, under the law of Pennsylvania, the procedure followed by petitioner and his wife was legally sufficient to completely divest the petitioner of the ownership and of the control of the undivided one-half interest in the furniture business

* These sections relate to wrongful act or omission by a partner acting in the ordinary course of the business of the partnership and a breach of trust by a partner acting within the scope of his apparent authority.

which he had formerly owned in its entirety and that, in the formation of a partnership with his wife, her status as a partner and as a co-owner of the partnership business was legally established. If they acted in good faith and the petitioner retained no control or dominion over the corpus or the income of the property owned by his wife, they are subject to Federal tax as "partners."

This court said in *Poe v. Seaborn,* 282 U.S. 101, 110, as follows:

> "What then is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor? The answer is found in the statutes of the state and the decisions interpreting them."

In *Blair v. Commissioner,* 300 U.S. 5, 9, this court, referring to the validity of an assignment of income of a testamentary trust said as follows:

> "The question of the validity of the assignments is a question of local law. The donor was a resident of Illinois and his disposition of the property in that state was subject to its law. By that law, the character of the trust, the nature and extent of the interest of the beneficiary and the power of the beneficiary to assign the interest in whole or in part, are to be determined. The decision of the state court upon these questions is final."

(See also *Helvering v. Fuller,* 310 U.S. 69, 74; *Morgan v. Commissioner,* 309 U.S. 78, 82).

In the case of *Helvering v. Stuart,* 317 U.S. 154, 161, Mr. Justice Reed says:

> "When Congress fixes a tax on the possibility of * * * the distribution of income, the 'neces-

sary implication,' we think, is that the possibility is to be determined by the state law. * * * Congress has selected an event * * * and has directed a tax to be levied if that event may occur. Whether that event may or may not occur, depends upon the interpretation placed upon the terms of the instrument by state law. *Once rights are obtained by local law, whatever they may be called, these rights are subject to the Federal definition of taxability.* (Italics supplied)."

IV. The Terms of the Agreement and the Acts of the Parties Evidence Good Faith and Petitioner's Lack of Control Over the Property and Income of His Wife.

The agreement of partnership executed by Petitioner and his wife is in evidence, (Exhibit No. 1, R. 48-52) it clearly recites the joint ownership of the parties of the retail furniture business in question and the contribution by each of them of their undivided one-half interest therein to be and to constitute the assets of the partnership. Throughout the entire agreement, the capital contribution and the one-half ownership of each partner is clearly and consistently recognized. The provisions of the agreement, fixing the respective capital interests and investments of the parties and their right to participate in the profits of the business are completely mutual. It is expressly provided in Article 8 of the agreement (R. 50) that "profits may be withdrawn by the partners at such times as both agree that said withdrawals may be made without injury to the welfare and expansion of the business."

The agreement also contains provisions relative to the purchase of the interest of a deceased partner and to the rights of the partners in event of dissolution or liquidation. Here, again, petitioner is given no greater rights and assumes no greater liabilities than does his wife.

The operation of the business, as distinguished from the distribution of its profits and the disposition of the capital interests or investments of the partners, is covered by Article 6 of the agreement which provides as follows (R. 49):

> "6. It is understood and agreed that the said ABRAHAM L. LUSTHAUS shall have full charge of the operation of all of the business of said partnership and shall act as Manager thereof, with full power to employ and discharge such persons as he may think advisable and necessary in the proper conduct of said business. In all matters in connection with the operation and management of said business the said ABRAHAM L. LUSTHAUS shall be in full control and shall have the final decision."

It should be noted that the above provision relates solely to the *operation and management of the business* of the partnership and confers on the petitioner absolutely no rights or preferences in so far as the distribution of profits or the disposition of capital investment is concerned. The appointment of a managing partner is not only proper but customary.

The power granted to petitioner as managing partner established nothing more than an agency relation; it did not make him the "owner" of the partnership interest or share of partnership income which belonged to his wife individually.

It is an accepted principle of law that power of management of a trust retained by the grantor, does not operate to bring the grantor of such power within the provision of the Internal Revenue Code, Section 22(a) (26 U.S.C. 669) (Appendix pp. 46-47) if by such power the *grantor derives no economic benefit. Jones v. Norris,* 122 F. (2d) 6. *Commissioner v. Branch,* 141 F. (2d) 985; *Commissoner v. Katz,* 139 F. (2d) 107. This principle applies with even greater force to the delegation of the power of management of a business to an agent who derives no preferential benefit therefrom.

The Tax Court refused to accept petitioner's status as a partner and to recognize, for income tax purposes, the partnership formed by petitioner and his wife. The effect of the decision is to deny that petitioner's wife became the owner of the property which she contributed to the partnership capital. The necessary implication is that all the things done by petitioner and his wife in the formation and subsequent conduct of the partnership business were merely superficial gestures not intended to be legally effective or to change petitioner's economic interests in the property and business initially owned and conducted by him. It is important, therefore, to examine in detail exactly what the parties actually did and what steps were taken by them to the end that a partnership might be established. The steps taken are well summarized by Judge Fake in his dissenting opinion filed in this case in the court below, (R. 71-73) as follows:

> "(1) The value of petitioner's business was ascertained from a statement made up from the books of the business and fixed at $230,507.62, as of January, 1940.

"(2) On January 12, 1940, petitioner withdrew $20,000 in cash from the business, thus reducing the value of the assets to $210,507.62.

"(3) On June 4, 1940, a partnership agreement was entered into between petitioner and his wife, taking effect retroactively on January 1, 1940, wherein the value of the assets is fixed at $210,507.62, because of the withdrawal of $20,000 as above mentioned.

"(4) On the same day, to wit, June 4, 1940, the petitioner executed and delivered to his wife a bill of sale transferring to her an undivided one-half interest of, in and to the assets of the business in consideration of the sum of $105,253.81.

"(5) Petitioner made his wife a present of $50,000, evidenced by his check, to be applied by her to the purchase price above mentioned and paid a gift tax thereon.

"(6) The wife gave petitioner her personal check for $50,253.81 to be applied on the purchase price, and executed and delivered to petitioner a series of eleven promissory notes each in the sum of $5,000 payable in one to eleven years, respectively, thus accounting for the full purchase price, and these notes have been paid as they matured.

"(7) The business is that of buying and selling household furniture, carried on in two stores, one known as Household Furniture Company and the other as Furniture Outlet Store, both in Uniontown, Pennsylvania.

"(8) Certificates to transact business as partners under these assumed or fictitious names were

duly filed in the Office of the Secretary of the Commonwealth and in the Office of the Prothonotary of Fayette County, pursuant to Pennsylvania law.

"(9) As of January 1, 1940, partnership books were opened and thereafter the profits of the partnership were equally divided between the partners on the books of the firm, and each partner thereafter made withdrawals therefrom, making deposits in their respective individual accounts.

"(10) The wife had a separate estate consisting of a dwelling valued at from $25,000 to $30,000 and securities valued at from $20,000 to $25,000 before and at the time she entered into the partnership.

"(11) Before the wife entered into the partnership she had for years helped out in the stores and after the partnership she functioned in like manner.

"(12) The bank with which the partnership had its account was not authorized to accept checks of the wife as a partner until 1943.

"(13) Social Security tax returns were filed after the partnership until 1941, reciting petitioner as owner.

"(14) The income tax return for the year 1940 was filed as a partnership return.

"(15) The partners instituted law suits in the partnership name." (R. 71-73).

In the majority opinion of the court below, it is suggested (R. 70) that the fact that the bank with which the partnership had its account was not expressly

notified to accept Mrs. Lusthaus' signature as a partner with authority to draw checks until 1943 "tends to justify" the decision of the Tax Court and that social security tax returns were filed, up until June, 1941, carrying petitioner's signature as "owner" rather than as "partner" would have the same effect. If these matters are actually considered of any substantial importance, it is of equal importance that petitioner testified (R. 22) that the failure to file his wife's signature with the bank *was a mere "oversight"* and that, since he had full charge of the business activities, there was no necessity or occasion for her to sign any checks. Petitioner testified with respect to the social security returns (R. 21) that this work was done by a bookkeeper upon whom he relied and that he signed these returns without examining their contents.

Petitioner submits that the significance of these matters, if they have any, lies in the fact that they are *omissions naturally occurring in the transition of the business from a sole proprietorship to a partnership.* Undoubtedly a number of other details were also overlooked. The very lack of completeness in the immediate correction of all business methods and procedure to the partnership basis negatives the existence of the planned subterfuge charged by the Tax Court and attests the genuineness and normalcy of the partnership operations. It is difficult to conceive that evidence of this type should be given any weight whatsoever in support of a charge of bad faith or lack of substance and reality in the property transfers and legally binding contracts upon which the partnership is founded. Petitioner submits that such trivialities fall far short of the accepted standard reaffirmed in *Commissioner v. Scottish American Co.*, 323

U.S. 119, 124 where Mr. Justice Murphy speaking for a unanimous court said:

> "When the Tax Court's factual inferences and conclusions are determinative of compliance with statutory requirements, the appellate courts are limited to a determination of whether they have any *substantial basis in the evidence.* * * * If a substantial basis is lacking, the appellate court may then indulge in making its own inferences and conclusions or it may remand the case to the Tax Court for further appropriate proceedings." (Italics supplied)

We have heretofore attempted to set out in chronological order exactly what petitioner and his wife did prior to and following the formation of their partnership. (pp. 2-8). It is impossible for petitioner to understand what further the parties could or should have done to more completely evidence the sincerity of their purpose which obviously was to create and conduct a business partnership in which they would be the joint owners and the profits of which they would equally divide for all purposes.

The attorney for the parties testified personally in this case and gave a clear-cut statement of the negotiations and conferences held with petitioner and his wife relative to formation of the partnership. He recited (R. 40-41) that he had first prepared a partnership agreement some time in the Fall of 1939 and gave the reasons why execution of the agreement was delayed so that the partnership should become effective January 1, 1940. He explained the delay incident to the actual execution of the agreement, occasioned first, by his illness and absence from the city and, later, by the absence of peti-

tioner and his wife. He further gives his personal observation of the manner in which the business of the partnership was conducted during 1940. It appears from the evidence (R. 42-43) that the proper certificates authorizing petitioner and his wife to carry on business under the Fictitious Names Act of the Commonwealth of Pennsylvania were executed by the petitioner and by his wife and were filed by their said attorney on or about July 31, 1940. The attorney attributes the delay in filing these certificates to the general delay and difficulties which he encountered in connection with getting the matter closed. (R. 43).

It is not contended that the filing under the Fictitious Names Act is necessarily conclusive proof of the validity of the partnership association. Petitioner submits, however, that it is strongly indicative of the intention of the partners to publicly confirm and recognize the changed economic status and ownership of the business that resulted upon the formation of their partnership. The Fictitious Names Act (Act of Assembly of the Commonwealth of Pennsylvania of June 28, 1917, P. L. 18, as amended), provides in part that no individual or individuals shall carry on or conduct any business in the Commonwealth of Pennsylvania under any assumed or fictitious name, style or designation unless such person or persons shall after advertisement, file a certificate in the Office of the Secretary of the Commonwealth and of the Prothonotary, setting forth the names and addresses of the persons owning or interested in said business.

The Supreme Court of Pennsylvania in the case of *Rowland v. Canuso*, 329 Pa. 72, 79, referring to this Act of Assembly, said as follows:

> "The purpose of the Fictitious Names Act was to protect those who deal with persons carrying on a business under an assumed name, and to enable them to know with whom they do business; * * * it also serves the purpose of identifying those against whom, in certain circumstances, claims for damages arising from either tort or contract, should be made."

Compliance with the Act was an effective notice to all parties and to the world at large that petitioner and his wife were the owners of the two stores conducted under the names of "Household Furniture Company" and "Furniture Outlet Store." It is difficult to know upon what theory their personal liability to creditors could thereafter be avoided.

The instruments executed by the parties evidence no bad faith or lack of intention on their part to be bound thereby. The terms of the partnership agreement evidence no retention of control by petitioner over the capital investment of his partner; it furnishes him no greater rights with respect thereto than does any normal partnership agreement. There is nothing in the agreement that prevents either party from withdrawing from the partnership and the conditions of withdrawal are entirely mutual. The property rights of each partner are fully protected and consistently recognized. The partnership business was conducted as such and the books of account were so maintained. (R. 7). Litigation was instituted in the partnership name (R. 41) and in all major respects the transition from sole proprietorship to a partnership was consistently carried through.

A business relationship is nonetheless valid because the parties are husband and wife and the "close scrutiny" which family partnerships quite properly receive, raises no presumption of fraud or bad faith or lack of reality. Petitioner submits that the "bona fides" of the transactions in question are unchallenged by any testimony in the record.

V. The Gift to Petitioner's Wife Was Complete and She Made an Actual Contribution to Partnership Capital.

It is frequently stated that a prerequisite to the formation of a valid partnership is the actual contribution of capital or services. However, such contribution must be "actual" only in the sense that complete ownership of a property interest results and is vested in the contributor. The source of a contribution to a partnership is of no importance if actual "co-ownership" of a business for profit results.

Petitioner submits that, in the instant case, he made a valid and complete gift of $50,000 to his wife vesting complete ownership in her and that she, in turn used this money as part of the consideration for the purchase from him of an undivided interest in his business. Petitioner asserts that this constitutes an actual contribution of her separately owned property to the partnership and that thus she became a co-owner with him in the conduct of a business for profit. The opinion of the Tax Court states that by "turning back" the gift given to the wife "conditionally" she acquired no "separate interest of her own" in the business. (R. 65) The implication is that

the wife owned nothing and, therefore, contributed nothing.

Such conclusion can be reached only by disregarding the realities of the case as well as the applicable principles of law. It is, in essence, a legal conclusion involving the common law rules of property. This is a field in which the Tax Court has no special province. It is not in that class of issues which is peculiarly within the competence of the Tax Court. The conclusion reached by the Tax Court is not "in accordance with law." It is a "clear-cut mistake of law."

A clear intention on the part of a donor to irrevocably divest himself of title and of dominion and control over the entire gift is fully recognized as one of the essential elements of a gift *inter vivos*. However, it is equally fundamental and a well recognized principle of law that a gift *inter vivos* does not become invalid or incomplete and that no incidents of ownership are retained by the donor when there is attached to the gift a condition which is not inconsistent with the prompt and complete vesting of unrestricted control in the donee. (See C. J. S., Vol. 38, Gifts, Sections 36, 37.) A gift of money to a wife or to a son or to a third party upon condition that it be invested to purchase a designated security is obviously nothing more in essence than a gift of the security itself. No possibility of reversion is occasioned by such a condition and no control or dominion is imposed which in any way affects or restricts the normal incidents of ownership. *Edson v. Lucas*, 40 Fed. (2) 398. *Beaumont v. Beaumont*, 152 Fed. 55.

On analysis, what actually occurred in the instant case was in essence the gift to petitioner's wife of an

undivided interest in the assets of his business to the extent of $50,000, a full one-half interest therein being valued at $105,000. It is submitted that the property rights of the parties were definitely changed by operation of law. The petitioner's wealth was decreased by $50,000 and petitioner's wife became the unrestricted owner of a partnership interest and her estate was increased accordingly. Concurrent execution of the partnership agreement evidences her contribution of said assets to the partnership capital.

VI. The Separate Economic Interests Created by the Transactions Involved Must Be Recognized for Income Tax Purposes.

From the opinion and decision of the Tax Court, it is self-evident that the court approached and examined the facts of record as though under some compulsion to attach to all transactions between Petitioner and his wife a lack of reality almost equal to a presumption of fraud and bad faith. We feel quite sure that this court did not intend that the doctrine announced in *Helvering v. Clifford*, 309 U. S. 5 should have such interpretation.

The essence of the Clifford decision in so far as it is applicable in the instant case is that a legally perfect gift of income producing property will not *necessarily* relieve the donor of tax liability on the income therefrom in a case where the transfer is a temporary intra-family arrangement and the transferor reserves to himself such a bundle of rights and incidents of control over both the corpus and the income of the gift that his economic position has not been changed and he remains in substance the true owner thereof. There lacks in the

instant case any semblance of control, either over the wife's capital investment, her property, or over her share of the partnership income. The sole similarity in the cases is that a husband and wife relationship is involved in each.

The accepted principle that taxation is a practical matter in which substance controls over form is not intended to grant permission to the courts to supplement and enlarge the provisions of the Federal revenue acts in order to prevent methods of tax reduction which Congress itself has not seen fit to correct. The principle still remains unchallenged that a taxpayer may, by lawful means, minimize his taxes. The intention to reduce taxes is under no circumstances to be considered as bad faith. *Gregory v. Helvering,* 293 U.S. 465. We do not understand that *Helvering v. Clifford, supra,* was intended to encourage or to permit the principles there announced to become a substitute for legislation which Congress has refused to enact or for regulations and procedure which the Respondent has so far refused to adopt.

Granting that the present provisions of the Internal Revenue Code which require recognition of a family partnership grounded on a bona fide, completed gift and a legal partnership agreement might be subject to abuse and may, when abused, open the door to tax avoidance, it is still not the province of the Tax Court or of the appellate court to close the door by arbitrary factual conclusions or by erroneous legal conclusions. The courts have no power to legislate. If Congress has permitted a gateway of avoidance, it is Congress that must close

the gate. The many bona fide family partnerships that exist should not be subjected to the penalty of non-recognition because of the possibility that fictitious and unreal partnerships may crowd through the same gate.

The Revenue Act of 1937, approved August 26, 1937 (59 Stat. 813; 26 U.S.C. 973) was captioned as "An act to provide revenue, equalize taxation, prevent tax evasion and avoidance and for other purposes." Prior to the passage of the Act, the President of the United States called to the attention of Congress certain methods of avoidance and evasion of tax liability brought to his attention by a letter from the Secretary of the Treasury. It was suggested that Congress enact legislation adequate to make the tax structure evasion proof. A letter from the Secretary of the Treasury to the President of the United States was directed to the attention of Congress. This letter listed eight separate and distinct methods alleged therein to be "devices employed by taxpayers for the purpose of defeating the income taxes which would be normally payable by them." (p. 1). Included in this list was the "device of husband and wife or father and children partnerships." (p. 3). Said letter also drew attention to the division of income between husband and wife in the community property states (Report of the Joint Committee of Tax Evasion and Avoidance, 75th Congress, First Session, House Document No. 337). These matters were referred to a Joint Committee of the Senate and House of Representatives of the United States and the report of said Committee was filed on August 5, 1937. This report is entirely silent on the subject of family partnerships although the other "devices" men-

tioned in said letter are commented upon. It made no suggestion on the subject of community property.

The Revenue Act of 1937, thereafter passed, left entirely unchanged all provisions relative to the taxation of family partnerships.

It is suggested that the fair inference from these facts, is that Congress was entirely satisfied with the then existing provisions for the taxation of partnership income. It is further suggested to your Honorable Court that Congress believed that any legislation attempting to ignore the common law rules of property between husband and wife would not only be invalid but would be highly discriminatory in view of the recognition afforded the division of income between husband and wife in the so-called community property states.

The fallaciousness of applying the rationale of the *Clifford* case to bona fide husband and wife partnerships is self-evident. The primary ground underlying the *Clifford* rule was that the donor in that case, by family relationship and by the terms of the instrument involved, retained the ability and right to recover the *subject matter of his gift.* Where, as in the instant case, the husband makes a bona fide, irrevocable and completed gift to his wife which she, forthwith, uses to acquire complete ownership of an interest in his business, the indispensable basis for attributing the partnership income to him is totally lacking because *he has lost all control, title and ownership to a part of the property which produces the income.*

Granting the possibility of benefits flowing to the husband indirectly from his wife by reason of the pre-

sumed entity of the family group there is, in the instant case, nothing further of any consequence whatsoever to add to the "bundle of rights" found in the *Clifford* case to evidence retention of the incidents of ownership. There exists no factual or legal basis for disputing the fact that, in the instant case, there was a definite and permanent change in the economic interests of the parties resultant upon their agreements and the legal, enforceable property and contract rights thereby established. The wealth of the petitioner was decreased by the gift which he made to his wife and the wealth of the wife was in turn increased. The separate estate of each of them was irrevocably changed and new and different liabilities were assumed, both by contract and by operation of law. Furthermore, the total assets of the partners, liable for partnership debts, were increased by her separate estate of more than $50,000. We venture to assert that the Respondent would be the first to assert upon the death of Petitioner's wife, that her estate includes for estate tax purposes, the one-half partnership interest here involved.

VII. An Assignment of Income Is Not Involved in This Case.

In view of the mandatory provisions of the Internal Revenue Code (Sections 181 and 182) petitioner submits that he, individually, cannot be held taxable on *all* of the net income of the partnership without completely ignoring the recognized principle of *Blair v. Commissioner*, *supra*, and related cases holding that tax liability on income from property is based on "ownership."

In *Blair v. Commissioner, supra,* the court said as follows (p. 12):

> "In the instant case the tax is upon income as to which in the general application of the revenue acts, the tax liability attaches to ownership. See Poe v. Seaborn, supra, Hoeper v. Tax Commission, 284 U.S. 206, 52 S. Ct. 120, 76 L. Ed. 248."

Lucas v. Earl, 281 U.S. 111, *Burnet v. Leininger,* 285 U.S. 136, and the later decisions of *Helvering v. Horst,* 311 U.S. 112 and *Helvering v. Eubank,* 311 U.S. 122, are all assignment of income cases and do not purport to overrule the fundamental principles announced in *Blair v. Commissioner, supra.*

In *Pearce v. Commissioner,* 315 U.S. 543 the issue was whether or not a divorced wife should be subject to income tax in respect of an annuity purchased for her by her husband pursuant to a separation agreement. Mr. Justice Douglas said as follows:

> "Such cases as Helvering v. Horst, 311 US 112, 85 L ed 75, 61 S Ct 144; Helvering v. Eubank, 311 US 122, 85 L ed 81, 61 S Ct 149, and Harrison v. Schaffner, 312 US 579, 85 L ed 1055, 61 S Ct 759, supra, are not opposed to this result. Those cases dealt with situations where the taxpayer had made assignments of income from property. He was held taxable on the income assigned by reason of the principle 'that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, whether to pay a debt or to make a gift, is within the reach' of the Federal income tax law. Harrison v. Schaffner, supra (312 US p. 580, 85 L ed 1056, 61 S Ct 759). But in those cases the donor or grantor

had 'parted with no substantial interest in property' other than the specified payments of income.' Id. (312 US p. 583, 85 L ed 1058, 61 S Ct 759). *Here he has parted with the corpus.* And 'the tax is upon income as to which, in the general application of the revenue acts, the tax liability attached to ownership.' Blair v. Commissioner of Internal Revenue, 300 US 5, 12, 81 L ed 465, 470, 57 S Ct 330." (Italics supplied)

The Commissioner, in brief and in argument before the court below, asserted that, from a tax standpoint, the partnership between petitioner and his wife cannot be distinguished from an assignment of his income to her and cites the decisions of this court referred to above. Such argument fails to state under what principle of law it is permissible to completely ignore the capital investment of more than $200,000 which was the essential and primary factor in producing the partnership income.

The deficiency notice sent by Respondent to the Petitioner did not assert that the partnership agreement was an anticipatory assignment of income but, on the contrary, as found by the Tax Court (R. 64), Respondent determined in his deficiency notice that "no bona fide partnership existed between petitioner and his wife in 1940 and that petitioner is taxable on all the profits of his furniture business for that year." Quite obviously, it is the *validity of a partnership status that is at issue,* or, more fundamentally, the question presented is whether or not petitioner's wife became the actual owner of income producing property. If *she did become the owner of such property, Respondent's dis-*

regard of her tax liability is necessarily erroneous and arbitrary.

If it be conceded that petitioner and his wife formed a legal, valid partnership to which both contributed capital essential in the business, the issue here is resolved in Petitioner's favor. Even if the arrangement for profit distribution, gave to the wife a disproportionate share of the partnership earnings, it is nevertheless true that the Tax Court erred in ignoring the taxable status of the parties, and in holding Petitioner taxable on income from property owned by his wife.

The issue before the Tax Court was whether the Commissioner erred in totally disregarding the partnership status and in attributing all of its income to petitioner. There is no averment that all the income of the partnership was in fact the result of petitioner's personal services. There is no averment that the terms of the partnership agreement represented an assignment of petitioner's earnings to his wife. On the contrary, it is consistently recognized that some, if not a large portion, of the partnership income was a result of the capital invested. As a matter of common knowledge, capital is a large and material income producing factor in the conduct of the retail furniture business.

Under the principles of law which have been hereinbefore discussed and giving consideration to the character of the business in question and the fact that capital was the material income producing factor in the business, it necessarily follows that the Tax Court's finding, that all the business income is taxable to the petitioner, is a mistake of law and of fact.

The distinction between *personal service income* and *capital income* and the duty of attributing each type of income to the tree upon which it grew is no less conclusive because, in a given case, both are involved and one type of income is larger or smaller than the other. The assignment of income doctrine of *Burnet v. Leininger, supra,* only applies to income the initial right to receive and the beneficial enjoyment of which *vests in one person,* and is anticipatorily assigned or *diverted to another person.* Such income in the hands of the assignee is obviously derivative. Irrespective of the ratio existing between personal service income and capital income in any given case, *if capital is in any measure an income producing factor* and the parties have formed a valid partnership, it is beyond the province or right of the Tax Court, interpreting and administering the provisions of the Internal Revenue laws, to *arbitrarily disregard the basic principle that tax liability on income from capital is based upon ownership.*

If the Respondent desired to raise the issue that the terms of the partnership agreement fix a distribution of profits which is, to some extent, an assignment of Petitioner's earnings, and that some undisclosed part of the earnings from petitioner's labor are being enjoyed by the wife, he should have made such a finding. The Tax Court cannot, by indirection, restate or change the single issue here involved and place upon the taxpayer the burden of proving facts which are neither essential nor relevant to such issue. The Tax Court must apply the principles of law which are applicable to the issue presented and to the facts adduced by petitioner to support his position with respect thereto. The issue here is the existence of a partnership.

Petitioner has shown, beyond question, that he has such status and that it is bona fide. Petitioner has met the full burden imposed upon him by law; he has shown that the Respondent is necessarily wrong, in that some part of the partnership income is necessarily taxable to Petitioner's wife.

The following comments of this court in *Helvering v. Taylor*, 293 U. S. 507, are applicable:

> "We find nothing in the statutes, the rules of the board or our decisions that gives any support to the idea that the commissioner's determination shown to be without rational foundation and excessive will be enforced unless the taxpayer proves he owes nothing or, liable at all, shows the correct amount. While decisions o the lower courts may not be harmonious, our attention has not been called to any that persuasively supports the rule for which the commissioner here contends.
>
> "Unquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid. Lucas v. Structural Steel Co. 281 U. S. 264, 271, 74 L. Ed. 848, 852, 50 S. Ct. 263; Wickwire v. Reinecke, 275 U. S. 101, 105, 72 L. Ed. 184, 186, 48 S. Ct. 43; Welch v. Helvering, 290 U. S. 111, 115, 78 L. Ed. 212, 215, 54 S. Ct. 8. Frequently, if not quite generally, evidence adequate to overthrow the commissioner's finding is also sufficient to show the correct amount, if any, that is due. See e. g. Darcy v. Commissioner of Internal Revenue (C. C. A. 2d) 66 F. (2d) 581, 585. But, where as in this case the taxpayer's evidence shows the commissioner's determination to be arbitrary and excessive it may not reasonably be held that he is

bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him."

In any event, to attribute all of the partnership income to petitioner is necessarily an error of law on the facts as found. The Tax Court's conclusion and decision is in error irrespective of the issue presented so long as it stands unassailed that capital actually owned by petitioner's wife produced some part of the partnership profit.

VIII. The Tax Court's Decision Is "Not in Accordance With Law," and the Decision of the Circuit Court Affirming It Should Be Reversed.

It was argued by the Respondent in the court below that the issues presented in this case should be included in those which, under the doctrine of *Dobson v. Commissioner,* 320 U. S. 49, are peculiarly within the competence of the Tax Court to resolve by reason of its specialized equipment and training and that the appellate court was not at liberty to substitute its own inferences and conclusions. Hence its decision must stand.

On the record it does not appear that the "mastery" in tax matters which has been attributed to the Tax Court has been displayed in the numerous cases involving family partnerships which have come before it for decision. It cannot be denied that numerous and conflicting theories have been advanced from time to time and that there is utter conflict in the decided cases, resulting in confusion to the taxpayer. In part, upon

this premise, it is urgently submitted that the problems of family partnerships are properly classified with those questions of constitutional adjudication, determination of local law questions and *common law rules of property* which are clearly "outside the special province of the Tax Court." *Trust u/w Mary Lily (Flager) Bingham, et al. v. Commissioner,* .... U. S. ...., 89 L. ed. advance opinions 1191.

The language of Mr. Justice Frankfurter in concurring opinion in the *Bingham case, supra,* is entirely applicable here (p. 12):

> "The interpretation of tax statutes and their application to particular circumstances are all matters peculiarly within the competence of the Tax Court. On the other hand, constitutional adjudication, determination of local law questions and *common law rules of property,* such as the meaning of a 'general power of appointment' or the application of the rules against perpetuities, are *outside the special province of the Tax Court.* See Paul, *Dobson v. Commissioner*: the Strange Ways of Law and Fact (1944) 57 Harv. L. Rev. 753, 847-48." (Italics supplied).

The reasoning implicit in the Tax Court's decision makes it entirely possible to "separate the elements" of the decision. Such process demonstrates that the main factor influencing the court was the *legally erroneous* conception, that the gift and sale were incomplete. This is a mistake of law.

Petitioner submits that the issue here involved is not within the range of questions as to which the Tax Court should have final say whether it be considered as a question "involving determination" of local law

questions and "common law rules of property" or as one involving the ordinary and accepted distinction between questions of law and questions of fact. Under either classification, it is reviewable. The majority opinion in *Trust u/w Mary Lily (Flager) Bingham, supra*, states as follows (p. 1195):

> "Hence, the statute *does not leave the Tax Court as the final arbiter of the issue whether its own decisions of questions of law are right or wrong.* That can only be ascertained upon resort to the prescribed appellate process by a consideration of the merits of the point of law involved and by its decision at the conclusion of the process, not before it begins. The fact that the Court of Appeals below, while accepting the Tax Court's findings of fact, has nevertheless reversed its decision, would seem not to leave the question of law decided so free from doubt that the mandate of the statute could rightly be disregarded on any theory." (Italics supplied)

In the same opinion, Chief Justice Stone says as follows (p. 1195):

> "Whether or not its decision is in accordance with law is a question which the statute, Int. Rev. Code, Article 1141(c)(1), expressly makes subject to review."

Petitioner, in the instant case, is not disputing the facts as found by the Tax Court to the extent that its findings are factual. It is the legal effect given to, and the legal conclusions based on admitted facts that are in issue. As we have heretofore pointed out, the whole structure of the Tax Court's reasoning is grounded upon a basic mistake of law and hence is built upon a false

foundation. It should be reversed. The court below was guilty of reversible error in accepting the erroneous legal conclusion of the Tax Court and in affirming the Tax Court's decision without substantial supporting evidince in the record. The court proceeded on the mistaken theory that such was its obligation and duty under the *Dobson* case, *supra.*

Petitioner further contends that, under the ruling of the *Dobson* case, *supra*; *Commissioner v. Scottish American Inv. Co., supra,* and other related decisions of this Court, the issue as to whether or not there exists any "substantial basis in the evidence" to support the factual inferences and conclusions of the Tax Court *is in itself a question of law.* The term "substantial evidence" or "adequate support in the evidence" has a generally accepted meaning. In *Edison Co. v. Labor Board,* 305 U.S. 175, 229 Mr. Chief Justice Hughes, speaking for the court, said:

> "We agree that the statute in providing that 'the findings of the Board as to the facts if supported by evidence, shall be conclusive' means supported by substantial evidence. * * * *Substantial evidence is more than a mere scintilla.* It *means such relevant evidence as a reasonable mind accepts as adequate to support a conclusion.*"

We are not intending to urge that the appellate court has the duty or right to weigh the evidence or to choose between conflicting inferences. We do most earnestly urge that it is the right and duty of the appellate courts to *identify scintilla evidence* and to make sure that factual findings or conclusions are grounded on evidence legally sufficient for such purpose. In the instant case

the sole evidence of control, aside from the alleged incompleteness of the gift because it was conditional, is the family relationship and one or two totally inconsequential details of operation which most naturally occurred.

It is submitted that this Court has not intended by its decisions to deprive the Appellate Court of the authority, on review, to discard an ultimate finding or conclusion which is without rational foundation and is reached in arbitrary disregard of the facts and the law. It is the duty and right of the Appellate Court to reverse a decision of the Tax Court which is grounded upon a mistake of law or upon factual findings for which there is no substantial supporting evidence in the record. The decision of the Tax Court in the instant case is not only grounded upon a basic mistake in the determination of a local law question and of common law rules of property (issues not within the special province of the Tax Court) but in addition is grounded upon factual conclusions which have no justification or support whatsoever in the record.

IX. Conclusion.

The Internal Revenue Code provides that individuals carrying on business in partnership shall be liable for income tax only in their individual capacity and that the net income of each shall include only his or her distributive share of partnershsip profits. The test of an individual's partnership status in the case in which the personal services rendered are not a factor is that such individual shall contribute to the partnership capital or otherwise become a co-owner with the other partners of a business conducted for profit. This is in substance, but a restatement of the basic principle of taxation, that the *actual owner* of income producing property is subject to tax on the income produced thereby.

Petitioner's wife became the *actual owner of income producing property* which she then contributed to the capital of the partnership business which she formed with her husband and thus became associated with him as co-owner of a business for profit. There is no basis in the evidence for a contrary conclusion. As a bona fide owner of an interest in the partnership, Petitioner's wife is taxable on her agreed share of the profits earned by the business and no issue involving the assignment of income is raised.

It is respectfully submitted that the Tax Court's conclusions that the Petitioner's wife acquired no separate interest of her own and that by the transactions in question there was no change in Petitioner's economic interest in the furniture business which he had theretofore owned individually are unsupported by any substantial evidence in the record and are clear-cut mistakes of

law. The issue upon which the Tax Court pronounced is one of local law and common law property rules, and is not one peculiarly within the competence of the Tax Court to resolve. The Tax Court's conclusion is not "allowable"; its decision is not in accordance with law and the decision of the Circuit Court affirming it should be reversed.

Respectfully submitted,

W. A. SEIFERT,
WILLIAM WALLACE BOOTH,
NORMAN D. KELLER,
PAUL E. HUTCHINSON,
Attorneys for Petitioner.

Of Counsel:
REED, SMITH, SHAW & MCCLAY,
JOSEPH W. RAY, JR.

APPENDIX.

Statutes and Regulations Involved.

Internal Revenue Code:

Sec. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U.S.C. 1940 ed. sec. 22.)

Sec. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U.S.C. 1940 ed., Sec. 181.)

Sec. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). (26 U.S.C. 1940 ed., Sec. 182.)

Sec. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. (26 U.S.C. 1940 ed., Sec. 3797.)

REPLY BRIEF ON BEHALF OF PETITIONER

FILE COPY

Office - Supreme Court, U. S.
FILED
JAN 7 1946
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

NO. 263.

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF ON BEHALF OF PETITIONER.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

W. A. SEIFERT,
WILLIAM WALLACE BOOTH,
NORMAN D. KELLER,
PAUL E. HUTCHINSON,
Attorneys for Petitioner.

Of Counsel:
REED, SMITH, SHAW & McCLAY,
747 Union Trust Building,
Pittsburgh, Pa.
JOSEPH W. RAY, JR.,
Fayette Title & Trust Building,
Uniontown, Pa.

SMITH BROS. CO. INC., LAW PRINTERS, 434-438 BOULEVARD OF ALLIES, PITTSBURGH, PA.

INDEX.

PAGE

SUBJECT INDEX:

1. The primary conclusion underlying the Tax Court's decision is an erroneous legal conclusion. In affirming this decision the Circuit Court accepts this basic conclusion as correct. The Tax Court's decision is necessarily wrong because aside from such conclusion, it finds no "warrant in the record" nor a reasonable basis in the law 1-4

2. Capital was the material income-producing factor in the business here involved 4-5

3. The issue involved in this case is the existence or non-existence of a valid, bona fide partnership. If bona fide it must be given recognition for tax purposes 5-7

APPENDIX INDEX:

Notice of Deficiency 8-9
Statement (Explanation of Adjustments) 9-15

TABLE OF CASES CITED:

Commissioner v. Scottish American Co., 323 U. S. 119 2

Helvering v. Clifford, 309 U. S. 331 2

Helvering v. Taylor, 293 U. S. 507 5

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

NO. 263.

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

REPLY BRIEF ON BEHALF OF PETITIONER.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

1. *The primary conclusion underlying the Tax Court's decision is an erroneous legal conclusion. In affirming this decision the Circuit Court accepts this basic conclusion as correct. The Tax Court's decision is necessarily wrong because aside from such conclusion, it finds no "warrant in the record" nor a reasonable basis in the law.*

Respondent's Brief calls for this Reply Brief principally because the argument there presented completely abandons the line of reasoning followed by the Tax Court and approved by the Circuit Court. The Respondent nowhere discusses the basic theory upon which the Circuit Court of Appeals decided that "the Tax Court's conclusion to the effect that the alleged partnership was not

bona fide" was reasonable and should be affirmed. The Tax Court grounded its decision on the basic proposition that the gift of $50,000.00 to Petitioner's wife, followed by its immediate and required use by her in the purchase of an interest in his business, was not a completed gift because of such condition, that *consequently she owned nothing* and *made no contribution of capital to the partnership*. The Circuit Court held, on appeal, that (R. 70) *"it could be inferred"* from such circumstances (referring to the conditional gift) that the wife had made no real contribution and that Petitioner had not irrevocably divested himself of the subject matter of the gift.

Respondent apparently abandons the basis on which the Circuit Court affirmed the Tax Court and elects to rely on *Helvering v. Clifford*, 309 U.S. 331, as permitting the rejection for tax purposes of all intra-family transfers.

As to the record facts, other than those relating to the circumstances of the gift and purchase, the Circuit Court says (R. 70), "Other evidence not specifically set out in the Findings of Fact *tends to justify* the Tax Court's decision." (italics supplied) That there is evidence in the record which merely "tends" to justify the Tax Court's conclusion cannot be accepted as a substitute for the requirement of this Court that the inferences and conclusions of the Tax Court must have "substantial basis in the evidence". *Com. v. Scottish American Co.*, 323 U.S. 119.

It is quite clear that without the legally erroneous assumption made by the Tax Court as its basic premise, the record contains no evidence legally sufficient to support the Tax Court's decision. Granting that its basic

legal conclusion is an error of law, the Tax Court's decision, grounded thereon, cannot stand.

As a matter of fact, the Tax Court made no finding of retained control or of bad faith, nor does its opinion indicate that it considered such a finding would be justified except when grounded on the erroneous legal theory that the gift was incomplete and vested no separate estate in the wife because it was conditional.

The power to manage evidences no right to the economic benefits flowing from the property managed, and there is no evidence that Petitioner undertook to exercise dominion over his wife's business profits. Petitioner's wife states that she used her profits withdrawn (R. 27) "for whatever I need."

The record shows (Ex. No. 16, R. 61) that during 1941 the wife's account was charged with $7,410.36 to pay income and other taxes and that she withdrew in cash the sum of $8,907.50. Even granting that $5,000.00 of this amount was used by her to pay her note, which matured in January, 1941, there remains an excess of $3,907.50. These 1941 withdrawals are entirely relevant to the 1940 issue since they obviously represent a distribution of 1940 profits following the closing of the books. Petitioner's wife had and used a personal bank account (R. 27) and there is no evidence or ground for presumption that her husband had or exercised any control or dominion whatsoever over her funds.

Respondent repeatedly asserts the existence of Petitioner's control over the business and its profits and over the corpus of the property transferred by Petitioner to his wife, but he fails to point to any facts or cir-

cumstances such as a reasonable mind might accept as adequate to support such assertion.

2. *Capital was the material income-producing factor in the business here involved.* Respondent states on Page 21 of his brief, referring to the Petitioner, as follows: "* * * The income of the business was derived largely from his personal services and ability as manager * * *." Respondent's argument is in a large part grounded upon this incorrect statement and assumption. Numerous cases cited by Respondent relate to partnerships in which personal service was obviously the major income-producing factor. This type of case is clearly inapplicable.

The facts are that in 1940 the sales of the partnership business amounted to $276,325.62, the purchases amounted to $158,932.09, and the inventory at the close of the year amounted to $50,616.68. (See Exhibit No. 3, R. 52 a.) It also appears from Exhibit No. 3 that during 1940 the partnership received interest in the sum of $15,489.35. The balance sheet of January 1, 1940 (Ex. No. 9, R. 57) and the balance sheet of December 31, 1940 (Ex. No. 11, R. 58) show that as of the beginning of the year the business owned leases receivable in the sum of $195,161.01 and that as of the end of the year it owned leases receivable amounting to $228,240.72. This asset represents furniture sold on bailment lease, a customary practice in Pennsylvania, and it is clear on analysis of the exhibits that the $15,489.35 income item of "Interest" represents interest earned on outstanding bailment leases. The necessity of capital is further evidenced by the fact that the business expense in 1940 included rent in the amount of $11,265.00 and miscellane-

ous expense in the amount of $26,952.00. (See Ex. No. 3, R. 52 a.)

As to Petitioner's ability as manager of the business, there is nothing in the record to support the presumption that it contributed in any unusual manner to the business income. It does appear in the testimony that the Petitioner and his wife were both away from the business for nearly two months and that salaries paid to others in 1940 amounted to $42,372.17. (Ex. 3, R. 52 a.)

It follows that Respondent's statement that the business income was derived largely from Petitioner's personal service and his ability as a manager is wholly incorrect, and that his argument based thereon is without merit.

3. *The issue involved in this case is the existence or non-existence of a valid, bona fide partnership. If bona fide it must be recognized for tax purposes.* Respondent urges (Br. 7) that there is a duty on the Petitioner to do something more than to show that the Commissioner's determination is erroneous. Respondent argues that in the absence of proof of the *exact portion* of the business income which is attributable to the capital investment of Petitioner's wife in the business, the Tax Court committed no error in sustaining the Commissioner's determination that *all* income in dispute was taxable to Petitioner. The decision of this Court in *Helvering v. Taylor*, 293 U.S. 507, appears to fully discredit Respondent's argument. (See Petitioner's Br. p. 38.)

It is Petitioner's contention that proof of the incorrectness of the Commissioner's determination is, in

itself, sufficient to show such determination to be arbitrary, excessive, and unreasonable.

It is pertinent in this connection to know with some certainty the issue raised by the Commissioner in his "Notice of Deficiency." The Tax Court in its Findings of Fact (R. 64) states as follows: "The Respondent determined in his deficiency notice that no bona fide partnership existed between Petitioner and his wife in 1940 and that Petitioner is taxable on all of the profits from his furniture business for that year." A copy of the letter of notification of said deficiency and of the statement explaining the income adjustments made, appears hereafter in Appendix pages 8 to 15. The explanation given by the Commissioner for adjustment of Petitioner's income is as follows: (Appendix p. 14)

> "The income from partnership represented in your individual tax return has been eliminated inasmuch as it has been held that no partnership existed between you and your wife and that your income from business, as adjusted, set forth in Adjustment 'A' above, was taxable to yourself; * * *"

Thereafter, Petitioner filed his petition for a redetermination of the alleged deficiency in income tax and requested the Tax Court to find and adjudicate that he and his wife were partners and that only one-half of the income of the partnership was taxable to Petitioner. The case came to trial on the issue thus presented, to wit, the existence or non-existence of a bona fide partnership and the Tax Court, after hearing, concluded and held as follows (R. 66):

> "Whether or not the arrangement which Petitioner made with his wife constituted a valid partnership under the laws of Pennsylvania, we do not

think it should be given recognition for federal income tax purposes."

On appeal to the Circuit Court the decision of the Tax Court was affirmed in the following language (R. 71):

> "We cannot say here that the Tax Court's conclusion to the effect that the alleged partnership was not bona fide, is unreasonable. The decison of the Tax Court is, therefore, affirmed."

The actual issue here involved is thus clearly defined as the partnership *status*. The profit-sharing basis has not been challenged.

Respectfully submitted,

W. A. SEIFERT,
WILLIAM WALLACE BOOTH,
NORMAN D. KELLER,
PAUL E. HUTCHINSON,
Attorneys for Petitioner.

Of Counsel:
REED, SMITH, SHAW & MCCLAY,
JOSEPH W. RAY, JR.

APPENDIX.

TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
2300 Farmers Bank Building,
Pittsburgh, Pennsylvania.
July 15, 1942.

OFFICE OF
Internal Revenue Agent in Charge
Pittsburgh Division

Mr. A. L. Lusthaus,
52 West Main Street,
Uniontown, Pennsylvania.

Sir:

You are advised that the determination of your income tax liability for the taxable year (x) 1940 discloses a deficiency of $22,419.98 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Pittsburgh, Penna., for the attention of IT:WPM-HIL. The signing and filing of this form will expedite the closing of your

return (x) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,

By
W. P. MAYS
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.
HIL/MM

STATEMENT

IT:WPM
HIL-90D

Mr. A. L. Lusthaus,
52 West Main Street,
Uniontown, Pennsylvania.

Tax Liability for the Taxable Year Ended December 31, 1940.

	Liability	Assessed	Deficiency
Income tax	$30,946.58	$8,526.60	$ 22,419.98

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated October 30, 1941; to your protest dated April 17, 1942; and to the statements made at the conferences held on May 1, 1942 and June 23, 1942.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return		$ 35,415.02
Unallowable Deductions and Additional Income		
(a) Income from business increased	$80,707.43	
(b) Contributions adjusted	568.00	
(c) Other deductions adjusted	2,600.00	83,875.43
Total		$119,290.45
Nontaxable Income and Additional Deductions		
(d) Income from partnership eliminated		40,140.00
Net income as adjusted		$ 79,150.45

EXPLANATION OF ADJUSTMENTS

(a) It has been determined that your income from business in 1940 amounted to $80,707.43 as explained in detail below, constituting the income during the entire calendar year 1940 from your business enterprises the Household Furniture Company and the Furniture Outlet Store. It has been determined that, under date of June 4, 1940, you and your wife, Mrs. Lillian C. Lusthaus, signed articles of agreement to associate yourselves as partners in the conduct of the business of the two enterprises mentioned above, in which articles of agreement reference was made to a bill of sale, also dated in June, 1940, but effective as of January 1, 1940, by which you sold and conveyed to your wife an undivided one-half

interest in and to said retail furniture and household furnishings businesses.

In consonance with this purported partnership organization you filed a partnership return of income, Form 1065, for the year 1940 in the name "Household Furniture Company", reporting thereon ordinary net income of $80,280.20 and under partners' shares of income, reporting $40,140.10 ordinary net income as the share of yourself and the same amount as the share of your wife.

Your claim that a partnership existed between you and your wife, Lillian C. Lusthaus, during the year 1940 has been denied.

Separate individual income and defense tax returns, Forms 1040, were filed by you and your wife on each of which individual returns $40,140.10, or one-half of the $80,280.20 ordinary net income on the partnership tax return, was reported in item 6, page 1, as income from partnership.

Inasmuch as it has been held that no partnership existed, the income that was reported on the tax return of the ostensible partnership, $80,280.20, as corrected by the several adjustments explained below to the adjusted amount of $80,707.43, has been determined to be your income from business, taxable to you and no part of which income is taxable to your wife, Lillian C. Lusthaus. In view of this decision, the amount of $40,140.00 reported by you as total income in item 12 of your tax return, has been eliminated by adjustment (d) explained below; in this connection the ten cent difference between the amount reported in item 6, $40,140.10, and the

amount reported as total income, $40,140.00, has been noted.

"Household Furniture Company"
An ostensible partnership, now held to have been the sole-proprietorship of Mr. A. L. Lusthaus.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by tax return for 1940, Form 1065, filed by this ostensible partnership			$80,280.20
Unallowable Deductions and Additional Income			
(1)	Bad debts disallowed	$3,002.40	
(2)	Legal fees disallowed	1,160.82	4,163.22
Total			$84,443.42
Nontaxable income and Additional Deductions			
(3)	Donations and advertising expense allowed	$1,135.99	
(4)	Additional compensation to employees	2,600.00	3,735.99
Net income adjusted			$80,707.43

It has been held that, in the absence of a partnership this net income adjusted constituted in its entirety, income taxable to you.

EXPLANATION OF ADJUSTMENTS

(1) The amount deducted as bad debts, $8,845.95, in item 20 of the tax return, Form 1065, has been allowed in the amount of $5,843.55, and disallowed in the amount of $3,002.40; the amount disallowed represented the ag-

gregate of small accounts receivable that were charged off the books but the worthlessness of which in 1940 had not been substantiated inasmuch as it was determined that substantial recoveries of portions of the accounts were being realized.

(2) The deduction of $1,160.82 legal fees has been disallowed inasmuch as said fees were paid for services relating to organization of the purported partnership and to the preparation of the Last Will and Testament of Lillian Lusthaus, deductions of this nature having been held to be unallowable.

(3) It has been held that the total of $1,135.99 for donations and for advertising, reported in detail in a schedule attached to the purported partnership return but not deducted in arriving at the ordinary net income reported on that return, constituted an allowable deduction against your income from business, in consequence of which said deduction has now been allowed as set forth above. As the result of this allowance, the one-half of $1,135.99, or $568.00, that you deducted as contributions in item 13, page 1, of your individual tax return has been disallowed by adjustment (b) following. In the tax return of the purported partnership, the $1,135.99 was reported in Column 10 of Schedule "J" as being deductible, one-half thereof by yourself and one-half by your wife.

(4) It has been determined that the amount of $2,600.00 additional compensation paid to certain of your employees constituted an allowable deduction against the income of your business; no part of that amount was deducted from the income reported in the tax return filed by the purported partnership. In consequence of the allowance of this $2,600.00 as a deduction from your

income from business, the same amount has been disallowed by adjustment (c), below, as other deductions on your individual tax return.

(b) The amount of $568.00 reported as a deduction for contributions in item 13, page 1, of your tax return, has been disallowed, inasmuch as this deduction constituted a part of the $1,135.99 that has been allowed in the foregoing adjustment (a), having been determined to constitute donations and advertising expense deductible against your income from business.

(c) The amount of $2,600.00 reported as a deduction for bonuses to employees in item 18, page 1, of your tax return, has been disallowed, inasmuch as this deduction has been allowed against your income from business, shown in the foregoing adjustment (a).

(d) The income from partnership reported in your individual income tax return has been eliminated, inasmuch as it has been held that no partnership existed between you and your wife and that your income from business as adjusted, set forth in adjustment (a), above, was taxable to yourself; the amount that you reported as income from partnership in item 6, page 1, of your tax return was $40,140.10; the amount that you reported in item 12, page 1, of your return, however, was only $40,140.00, in consequence of which the amount here eliminated is $40,140.00.

Personal exemption, $2,000.00, claimed by your wife on her tax return has been allowed as a deduction against her taxable income.

Credit for dependents in the amount of $800.00 has been allowed, no part of this credit having been claimed in your tax return; it has been determined that you actually supported two dependent children, in consequence

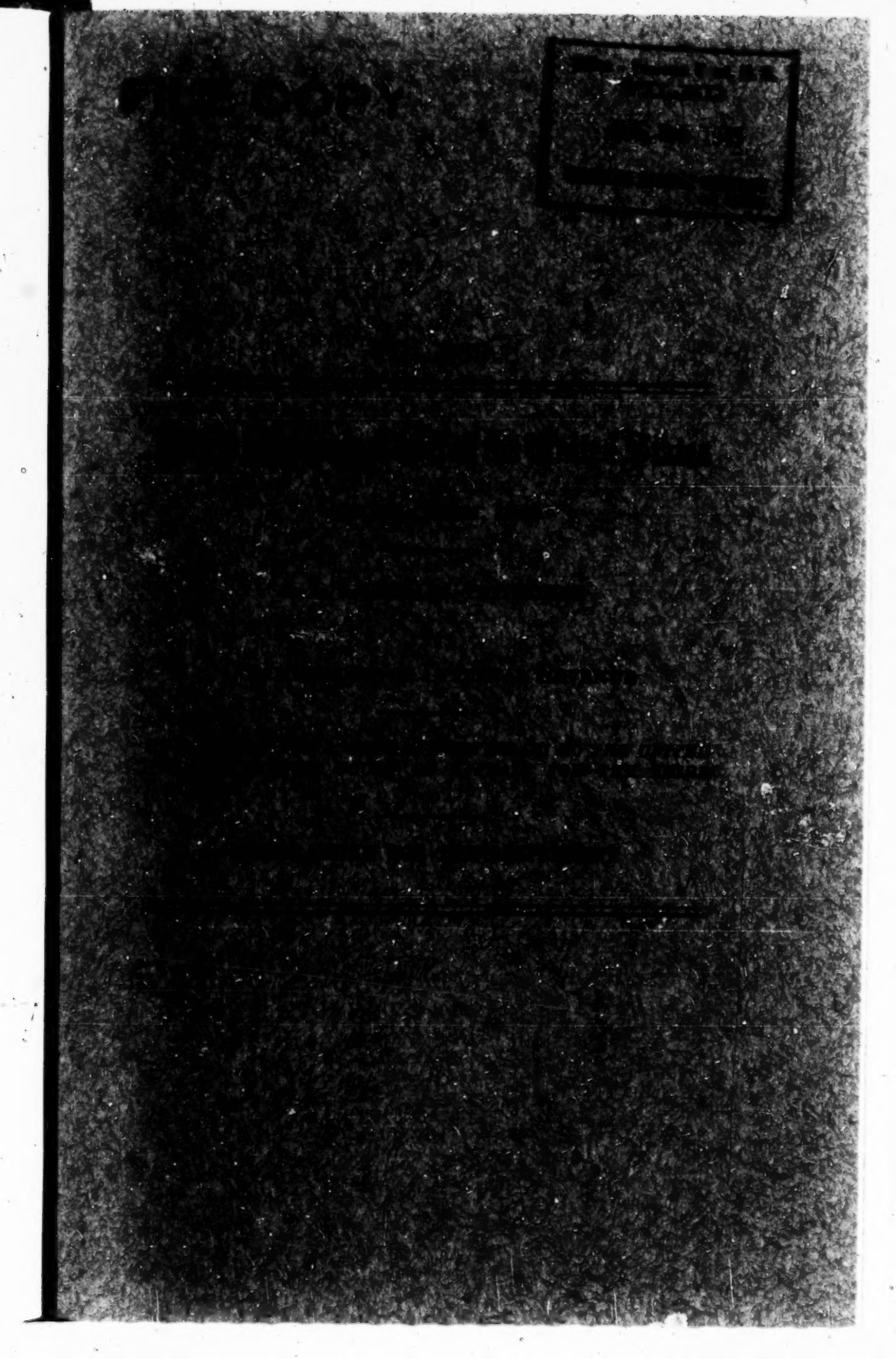
of which this credit has been allowed to you instead of to your wife who claimed this credit in her tax return.

The earned income credit $802.81, deducted in item 26, page 1, of your tax return has been increased by $597.19, as it has been determined that your corrected earned income credit was 10% of 20% of $80,707.43, your corrected income from business, but allowable only in the amount of $1,400.00.

COMPUTATION OF TAX

Net income adjusted	$79,150.45
Less:	
Credit for dependents	800.00
Balance (surtax net income)	$78,350.45
Less:	
Earned income credit (10% of $14,000.00)	1,400.00
Net income subject to normal tax	$76,950.45
Normal tax at 4% on $76,950.45	$ 3,078.02
Surtax on $78,350.45 (Amount in excess of $4,000.00)	25,055.23
Total tax (ordinary)	$28,133.25
Defense tax (10% of $28,133.25)	2,813.33
Corrected tax liability	$30,946.58
Income tax assessed:	
Original, account No. 205609	8,526.60
Deficiency of income tax	$22,419.98

HIL/MMM



In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 263

A. L. LUSTHAUS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

MEMORANDUM FOR THE RESPONDENT

We do not oppose the granting of a writ of certiorari in this case.

The question is whether an asserted partnership between the taxpayer and his wife shall be recognized for federal income tax purposes. The Tax Court held that the formalities by which the taxpayer gave money to his wife to enable her to buy an interest in his furniture business, made a deed of gift to her of a one-half interest in such business and executed a partnership agreement with her, made no change in the taxpayer's economic interests in the business and was merely a super-

662896—45

ficial arrangement for the obvious, if not the sole, purpose of reducing income taxes. It held, therefore, that the income of the business continued to be taxable to the husband. The Circuit Court of Appeals, treating the question as one essentially of fact, affirmed the Tax Court on the ground that there was substantial sustaining evidence in the record.

Under similar facts, however, the Circuit Court of Appeals for the Sixth Circuit, reversing a Tax Court decision, held that a partnership did exist for tax purposes. *Tower* v. *Commissioner,* 148 F. 2d 388.

The cases would seem to be in fundamental conflict in both rationale and result. The Government has filed a petition for certiorari in the *Tower* case on the basis, *inter alia,* of conflict with the instant case. This Court is respectfully referred to that petition for a comprehensive statement of the conflict and the importance of its resolution to the administration of the tax laws.

Respectfully submitted.

HAROLD JUDSON,
Acting Solicitor General.

AUGUST 1945.

U. S. GOVERNMENT PRINTING OFFICE: 1945

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Summary of argument	6
Argument: The Tax Court committed no error of law in deciding that the income in dispute was includible in the petitioner's gross income as defined by Section 22 (a) of the Internal Revenue Code, although that income was ascribed to his wife by a partnership agreement	7
Conclusion	29
Appendix	30

CITATIONS

Cases:

Argo v. *Commissioner*, 150 F. 2d 67, certiorari denied November 5, 1945	13, 15, 16, 22, 27
Bardach v. *Commissioner*, 90 F. 2d 323	27
Blair v. *Commissioner*, 300 U. S. 5	26
Bradshaw v. *Commissioner*, 150 F. 2d 918	13, 15, 16, 27
Buchanan v. *Commissioner*, 20 B. T. A. 210	13
Burk-Waggoner Assn. v. *Hopkins*, 269 U. S. 110	12
Burnet v. *Leininger*, 285 U. S. 136	8, 9, 14, 28
Burnet v. *Wells*, 289 U. S. 670	10
Cohan v. *Commissioner*, 39 F. 2d 540	13, 15
Commissioner v. *Court Holding Co.*, 324 U. S. 331	10, 17
Commissioner v. *Harmon*, 323 U. S. 44	9, 10, 26, 28
Commissioner v. *Scottish American Co.*, 323 U. S. 119	17
Commissioner v. *Smith*, 324 U. S. 177, rehearing denied 324 U. S. 695	11, 23
Commissioner v. *Tower*, No. 317, this Term	7, 18, 27
Corliss v. *Bowers*, 281 U. S. 376	10
Covington v. *Commissioner*, 103 F. 2d 201	13, 27
De Korse v. *Commissioner*, 5 T. C. 94	14, 17
Dobson v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231	17
Doll v. *Commissioner*, 149 F. 2d 239, certiorari denied October 8, 1945	13, 14, 16
Douglas v. *Willcuts*, 296 U. S. 1	8, 9
Earle v. *Commissioner*, 38 F. 2d 965	12

Cases—Continued

	Page
Earp v. *Jones*, 131 F. 2d 292, certiorari denied, 318 U. S. 764	13, 15, 25
Eaton v. *Commissioner*, 37 B. T. A. 283, affirmed *per curiam*, 100 F. 2d 1013, certiorari denied, 307 U. S. 636	13
Edson v. *Lucas*, 40 F. 2d 398	27
Fisher v. *Commissioner*, 29 B. T. A. 1041, affirmed *per curiam*, 74 F. 2d 1014	13, 15
Fox v. *Commissioner*, 5 T. C. 242	14, 17
German v. *Commissioner*, 2 T. C. 474	16
Grant v. *Commissioner*, 150 F. 2d 915	13, 15, 16, 25, 27
Gregory v. *Helvering*, 293 U. S. 465	10, 23, 29
Greenberg v. *Commissioner*, 5 T. C. No. 90	14, 17
Griffiths v. *Commissioner*, 308 U. S. 355	10, 29
Gulf Oil Corp. v. *Lewellyn*, 248 U. S. 71	11
Harrison v. *Schaffner*, 312 U. S. 579	10, 15, 16, 28
Hash v. *Commissioner*, 4 T. C. 878	13
Heiner v. *Mellon*, 304 U. S. 271	12
Helvering v. *Clifford*, 309 U. S. 331	6, 8, 9, 10, 11, 15, 17, 22, 23, 24, 25, 26, 29
Helvering v. *Eubank*, 311 U. S. 122	6, 9, 10, 14, 28
Helvering v. *Fuller*, 310 U. S. 69	10
Helvering v. *Horst*, 311 U. S. 112	6, 9, 10, 28
Higgins v. *Smith*, 308 U. S. 473	8, 10, 23
Interstate Transit Lines v. *Commissioner*, 319 U. S. 590	28
Irwin v. *Gavit*, 268 U. S. 161	9
Johnston v. *Commissioner*, 3 T. C. 799	17
Jones v. *Page*, 102 F. 2d 144, certiorari denied, 308 U. S. 562	14
Lorenz v. *Commissioner*, 3 T. C. 746; affirmed *per curiam*, 148 F. 2d 527, petition for rehearing denied October 15, 1945	13, 15, 16, 27
Losh v. *Commissioner*, 145 F. 2d 456	15, 27
Lowry v. *Commissioner*, 3 T. C. 730	13
Lucas v. *Earl*, 281 U. S. 111	6, 8, 9, 10, 14, 16, 28
Mauldin v. *Commissioner*, 5 T. C. No. 91	14, 16, 17
McEachern v. *Commissioner*, 5 T. C. 23	13, 16, 17
McIntyre v. *Commissioner*, 37 B. T. A. 812	13
Mead v. *Commissioner*, 131 F. 2d 323, certiorari denied, 318 U. S. 777	13, 15, 17, 27
Miller v. *Commissioner*, 150 F. 2d 823	13, 15, 16, 23, 27
Morrissey v. *Commissioner*, 296 U. S. 344	12
Munter v. *Commissioner*, 5 T. C. 39	13, 17
Neuberger v. *Commissioner*, 311 U. S. 83	11
Robertson v. *Commissioner*, 20 B. T. A. 112	13
Rose v. *Commissioner*, 65 F. 2d 616	27
Rossmore v. *Commissioner*, 76 F. 2d 520	11
Scherer v. *Commissioner*, 3 T. C. 776	17

Cases—Continued

	Page
Schroder v. *Commissioner*, 134 F. 2d 346	13, 14, 27
Sewell, Estate of v. *Commissioner*, decided November 9, 1945	13, 15, 17
Singletary v. *Commissioner*, 5 T. C. 365	14, 17
Smith v. *Commissioner*, 3 T. C. 894	17
Southern Pacific Co. v. *Lowe*, 247 U. S. 330	11
Supornick v. *Commissioner*, 150 F. 2d 110	13, 15, 16
Thorrez v. *Commissioner*, 5 T. C. 60	13, 16, 17
Tinkoff v. *Commissioner*, 120 F. 2d 564, certiorari denied, 314 U. S. 581	13, 14
Tyson v. *Commissioner*, 146 F. 2d 50	28
United States v. *Joliet & Chicago R. Co.*, 315 U. S. 44	11
United States v. *Phellis*, 257 U. S. 156	11
Villere v. *Commissioner*, 133 F. 2d 905	13, 15
Waldburger v. *Helvering*, 131 F. 2d 598	13, 17
Weiss v. *Stearn*, 265 U. S. 242	11
Welch v. *Helvering*, 290 U. S. 111	28
Wilmington Co. v. *Helvering*, 316 U. S. 164	17

Statutes:

Internal Revenue Code:

Sec. 11 (26 U. S. C. 11)	12, 30
Sec. 22 (26 U. S. C. 22)	8, 10, 30
Sec. 181 (26 U. S. C. 181)	11, 30
Sec. 182 (26 U. S. C. 182)	12, 30
Sec. 183 (26 U. S. C. 183)	12, 31
Sec. 184 (26 U. S. C. 184)	12
Sec. 185 (26 U. S. C. 185)	12
Sec. 186 (26 U. S. C. 186)	12
Sec. 187 (26 U. S. C. 187)	12
Sec. 188 (26 U. S. C. 188)	12, 31
Sec. 1003 (26 U. S. C. 1003)	18
Sec. 1004 (26 U. S. C. 1004)	18
Sec. 3797 (26 U. S. C. 3797)	12, 31

Miscellaneous:

Paul, Partnership in Tax Avoidance, 13 Geo. Wash. L. Rev. (1945):

P. 121	8
P. 122	11
Treasury Regulations 103, Sec. 19.22 (a)–1	32

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 263

A. L. LUSTHAUS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of facts and opinion of the Tax Court (R. 62–66) are reported at 3 T. C. 540. The opinion of the Circuit Court of Appeals (R. 68–71) and the dissenting opinion (R. 71–78) are reported at 149 F. 2d 232.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 11, 1945 (R. 79) and a petition for rehearing was denied on May 28, 1945 (R. 86). The petition for a writ of certiorari was filed on July 26, 1945, and granted on October

8, 1945. (R. 87). The jurisdiction of this Court was invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below erred in sustaining the decision of the Tax Court that the income attributed to petitioner's wife under a so-called partnership agreement was includible in his gross income as defined by Section 22 (a) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations are set forth in the Appendix, *infra*, p. 30.

STATEMENT

The Tax Court found the following facts (R. 62–64):

For several years prior to 1940, the petitioner had operated as sole proprietor a retail furniture business at two stores in Uniontown, Pennsylvania, known, respectively, as the Household Furniture Company and the Furniture Outlet Store. (R. 62.)

During 1939, the petitioner had several conferences with an accountant and an attorney about bringing his wife into his furniture business as a partner. In the latter part of 1939 it was decided that he would "sell" to her a half interest in the business and make her an equal partner as of January 1, 1940. The petitioner instructed the

accountant to determine the value of the business and make the necessary changes in the books of accounts. He also instructed the attorney to prepare the necessary legal papers. (R. 63.)

The net value of the business, based on book value of all physical assets and inventory, but excluding good will, was determined to be approximately $230,000. It was decided that the petitioner would withdraw $20,000 from the business, leaving a net worth of approximately $210,000; that he would make his wife a gift of $50,000 to be used in part payment for a half interest in the business; and that she would give the petitioner her promissory notes in the amount of the balance, $55,000, payable $5,000 annually. The petitioner told his wife of the plan and she agreed to it. (R. 63.)

The formalities of the transfer were delayed, first by the illness of the petitioner's attorney in December of 1939, then by his absence in January and February of 1940, and finally by the absence of the petitioner and his wife in March and April of 1940. (R. 63.)

On June 4, 1940, the petitioner executed a bill of sale covering an undivided half interest in his furniture business for a stated consideration of $105,253.81, one-half of the estimated value of the business on December 31, 1939. On the same day the petitioner's wife executed a partnership agreement, and a few days later the petitioner borrowed $25,000 and gave her a check for $50,000.

This check was drawn against the funds which he had previously withdrawn from the business and also against those borrowed from the bank. The petitioner's wife then gave him her check dated June 18, 1940, for $50,253.81; and, as previously agreed upon, executed and delivered to him eleven promissory notes for $55,000, in payment of the balance of the purchase price for her interest in the partnership. At that time, she owned her home, valued at $25,000 or $30,000; and securities of $20,000 or $25,000. (R. 63.)

A certificate authorizing the petitioner and his wife to carry on business under the fictitious name of Household Furniture Company was issued by the Commonwealth of Pennsylvania on July 31, 1940. The petitioner filed a gift tax return for 1940 in which he reported a gift to his wife of $50,000 on January 1, 1940. (R. 63–64.)

The petitioner's furniture business was conducted in substantially the same manner after the consummation of the partnership arrangements as before. He continued to manage the business, as he was authorized to do by the partnership agreement. His wife helped out at the stores—or one of them—whenever she was needed, just as she had always done. She took no active part in the management of the business, and never received any compensation for her services. (R. 64.)

Prior to 1940, the petitioner and his wife had maintained a joint bank account. Some time in

1940 they opened separate accounts. A separate account was maintained for the business in the name of the Household Furniture Company. During 1940, the tax year involved, the wife withdrew $59.61 from the business, and the petitioner withdrew $4,604.76. The corresponding figures for the following year are $16,317.86 and $19,198.69. The petitioner's wife paid three of the eleven promissory notes executed under the partnership agreement as they became due. At the close of each year, the profits of the business were credited on the books to the petitioner and his wife equally. (R. 64.)

A partnership return filed in the name of the Household Furniture Company showed a net profit of $80,280.20 in 1940. The petitioner and his wife each reported one-half of that amount (less partnership contributions of $1,135.99) in their individual returns for 1940. (R. 64.)

The Tax Court sustained the determination by the Commissioner that the petitioner and his wife were not partners for purposes of the federal income tax, and that the petitioner was liable for tax on all of the profits from the furniture business for that year, which, with adjustments made in the deficiency notice and not put in controversy, amounted to $84,443.42. (R. 64–66.) The Circuit Court of Appeals affirmed the decision of the Tax Court. (R. 68–71, 79.)

675708—45——2

SUMMARY OF ARGUMENT

The Tax Court committed no error of law in deciding that income ascribed to the petitioner's wife by the partnership agreement was includible in his gross income for purposes of Section 22 (a) of the Internal Revenue Code.

The effectiveness for tax purposes of family partnership arrangements like that here involved must be tested by the fundamental principles that taxation is concerned with economic realities and not with refinements of legal title; that an anticipatory assignment of income, however, skillfully devised, is ineffective to relieve the donor of tax liability (*Lucas* v. *Earl,* 281 U. S. 111; *Helvering* v. *Horst,* 311 U. S. 112; *Helvering* v. *Eubank,* 311 U. S. 122); and that a legally perfect gift of income-producing property will not relieve the donor of tax on future income unless it operates to deprive him of such measure of the economic benefits of ownership, direct and indirect, that he may no longer be said to be the substantial owner of the property (*Helvering* v. *Clifford* 309 U. S. 331). The Tax Court correctly applied these principles, and its decision that the share of profits ascribed to the petitioner's wife by the partnership agreement was to be attributed to the respondent for tax purposes is entitled to finality since it had a rational basis in the evidence.

The Tax Court did not err in deciding that the petitioner's wife was not a partner with him for any relevant purpose, since it clearly appeared that she had made no substantial contribution of services or capital to the purported partnership. This decision is confirmed by other circumstances. The petitioner retained complete powers of management of the business, and power to deny his wife any distribution of its profits. He received no salary for his services, although they contributed in large measure to the income in question; and the wife was credited with a half interest in the profits, although her services were relatively unimportant.

On these facts, and in the absence of any effort by the petitioner to prove what portion, if any, of the income ascribed to the wife was actually derived from her insubstantial contributions to the business, the Tax Court committed no error in sustaining the Commissioner's determination that the income in dispute was includible in the petitioner's gross income.

ARGUMENT

THE TAX COURT COMMITTED NO ERROR OF LAW IN DECIDING THAT THE INCOME IN DISPUTE WAS INCLUDIBLE IN THE PETITIONER'S GROSS INCOME AS DEFINED BY SECTION 22 (a) OF THE INTERNAL REVENUE CODE, ALTHOUGH THAT INCOME WAS ASCRIBED TO HIS WIFE BY A PARTNERSHIP AGREEMENT

Like the respondent in *Commissioner* v. *Tower*, No. 317, October Term, 1945, the petitioner in this

case contends that the Commissioner and the Tax Court were bound as a matter of law to exclude from his gross income as defined by Section 22 (a) of the Internal Revenue Code (Appendix, *infra*) the share of business profits ascribed to his wife by the partnership agreement.

1. The family partnership form should be no more effective in deflecting income for tax purposes than are the forms of an irrevocable assignment, the family trust, or the wholly-owned corporation, which have often been denied effect for tax purposes by this Court. E. g., *Lucas* v. *Earl*, 281 U. S. 111; *Burnet* v. *Leininger*, 285 U. S. 136; *Douglas* v. *Willcuts*, 296 U. S. 1; *Helvering* v. *Clifford*, 309 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473. That the revenue laws contain special provisions with reference to partnerships of course affords no warrant for a contrary assertion. The revenue laws also contain special provisions for taxing trusts and corporations, yet numerous cases in this Court, including cases cited above, clearly establish that those forms do not prevent application of Section 22 (a).[1] See also, Paul, *Partnerships in Tax Avoidance*, 13 Geo. Wash. L. Rev. 121 (1945).

---

[1] *Douglas* v. *Willcuts*, *supra*, involved the question whether the income of a trust was to be taxed to the grantor because of benefits which he enjoyed from payment of income to the beneficiary. This Court held in the affirmative, and in the course of its opinion said (296 U. S., pp. 9–10):

> We do not regard the provisions of the statutes as to the taxation of trusts, fiduciaries, and beneficiaries

In defining gross income in Section 22 (a), Congress exercised to the fullest extent its constitutional power to tax income. *Irwin* v. *Gavit*, 268 U. S. 161, 166; *Douglas* v. *Willcuts*, 296 U. S. at 9; *Helvering* v. *Clifford*, 309 U. S. at 334. The broad reach of that power, both in relation to what is income and who is to be taxed, is apparent from numerous decisions of this Court. An assignment of income to be earned or to accrue in the future, even though authorized by state law and irrevocable in character, is ineffective to render the income immune from taxation as that of the assignor. *Commissioner* v. *Harmon*, 323 U. S. 44, 46; *Lucas* v. *Earl*, *supra*; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; *Burnet* v. *Leininger*, *supra*. "The power to dispose of income is the equivalent of ownership of it" (*Helvering* v. *Horst*, 311 U. S. at 118); and a transaction will not insulate the taxpayer from liability for the tax on income derived from property unless it deprives him of

(Revenue Acts, 1926, § 219; 1928, § 161, 162), as intended to apply to cases where the income of the trust would otherwise remain, by virtue of the nature and purpose of the trust, attributable to the creator of the trust and accordingly taxable to him. These provisions have appropriate reference to cases where the income of the trust is no longer to be regarded as that of the settlor, and we find no warrant for a construction which would preclude the laying of the tax against the one who through the discharge of his obligation enjoys the benefit of the income as though he had personally received it.

the attributes of substantial ownership as that term is employed in the federal law to designate retained control or other enjoyment of economic benefits (*Helvering* v. *Clifford, supra*; *Helvering* v. *Fuller,* 310 U. S. 69, 76, fn. p. 72; *Harrison* v. *Schaffner,* 312 U. S. 579; cf. *Burnet* v. *Wells,* 289 U. S. 670). Section 22 (a) is "not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid". *Harrison* v. *Schaffner,* 312 U. S. at 581; *Corliss* v. *Bowers,* 281 U. S. 376, 378. Accordingly, mere passage of title to income-producing property through devices which are valid under state law does not require that future income from the property be excluded from the grantor's gross income under Section 22 (a), particularly where family arrangements are involved (*Helvering* v. *Clifford, supra*; *Helvering* v. *Horst, supra*); the taxpayer may remain liable for tax on income even though title to the property from which it has been derived or to the income itself has "vested" in another under state law (*Lucas* v. *Earl, supra*; *Helvering* v. *Eubank, supra*; *Commissioner* v. *Harmon, supra; Commissioner* v. *Court Holding Co.,* 324 U. S. 331); and corporations validly organized under state law may be ignored where they would serve merely to shift tax liability (*Gregory* v. *Helvering,* 293 U. S. 465; *Griffiths* v. *Commissioner,* 308 U. S. 355; *Higgins* v. *Smith,* 308 U. S. 473).

In sum, the decisions of this Court demonstrate that taxation is an intensely practical process which operates on the substance of transactions, whatever may be their form, and that retained command over income or its source or other enjoyment of economic benefits marks the real owner for income tax purposes. See also, *Commissioner* v. *Smith*, 324 U. S. 177, rehearing denied, 324 U. S. 695; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *Weiss* v. *Stearn*, 265 U. S. 242; *United States* v. *Phellis*, 257 U. S. 156; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330. And where, as in the present case, an intra-family transaction is involved, "special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as § 22 (a) is concerned". *Helvering* v. *Clifford*, 309 U. S. at 335.

2. Family partnership cases follow in a sense *a fortiori* from the trust and corporation cases cited above, since, unlike trusts and corporations, partnerships are not accorded the status of separate taxable entities. Paul, *Partnership in Tax Avoidance*, *supra*, p. 122; cf. *Neuberger* v. *Commissioner*, 311 U. S. 83. In general, partnerships are recognized only for information purposes. *Rossmoore* v. *Commissioner*, 76 F. 2d 520, 521 (C. C. A. 2d). Section 181 of the Internal Revenue Code (Appendix, *infra*), provides that indi-

viduals carrying on business in partnership shall be liable for income tax only in their individual capacity. Individual liability is imposed by Section 11 (Appendix, *infra*); and Section 182 (Appendix, *infra*) prevents the existence of a partnership from altering the normal incidence of the tax, by providing that the partners shall include in their net income their distributive shares of partnership income, whether or not distribution is actually made. Cf. *Heiner* v. *Mellon*, 304 U. S. 271; *Earle* v. *Commissioner*, 38 F. 2d 965 (C. C. A. 1st).[2]

We acknowledge that the Commissioner is bound to accept the agreed division of the profits for purposes of applying Section 22 (a) to measure the individual liability of each partner, where a partnership has been truly organized for business purposes and is employed by the parties for the carrying on of business in partnership within the meaning of Section 181. But under the principles discussed above, the Commissioner is not required to recognize every family partnership agreement or to give tax effect to the agreed divi-

[2] See also Sections 183–188 with respect to partnership income.

In addition to these provisions, the Internal Revenue Code sets forth, in Section 3797 (a) (2) (Appendix, *infra*), a general definition of partnerships. While this definition does not affect the present case, it is to be noted that it is applied with reference to exclusively federal concepts. E. g., *Burk-Waggoner Assn.* v. *Hopkins*, 269 U. S. 110; *Morrissey* v. *Commissioner*, 296 U. S. 344.

sion of profits therein. In accordance with those principles, the Circuit Courts of Appeals and the Tax Court have repeatedly held in an impressive number of cases that he need not do so where the purported partnership amounts to nothing more than a reallocation of income within the family.[3]

[3] *Doll* v. *Commissioner*, 149 F. 2d 239 (C. C. A. 8th), certiorari denied October 8, 1945; *Lorenz* v. *Commissioner*, 3 T. C. 746, affirmed *per curiam*, 148 F. 2d 527 (C. C. A. 6th), petition for rehearing denied October 15, 1945; *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. C. A. 2d); *Fisher* v. *Commissioner*, 29 B. T. A. 1041, affirmed *per curiam*, 74 F. 2d 1014 (C. C. A. 2d); *Eaton* v. *Commissioner*, 37 B. T. A. 283, affirmed *per curiam*, 100 F. 2d 1013 (C. C. A. 2d), certiorari denied, 307 U. S. 636; *Cobington* v. *Commissioner*, 103 F. 2d 201 (C. C. A. 5th); *Tinkoff* v. *Commissioner*, 120 F. 2d 564 (C. C. A. 7th), certiorari denied, 314 U. S. 581; *Earp* v. *Jones*, 131 F. 2d 292 (C. C. A. 10th), certiorari denied, 318 U. S. 764; *Mead* v. *Commissioner*, 131 F. 2d 323 (C. C. A. 5th), certiorari denied, 318 U. S. 777; *Waldburger* v. *Helvering*, 131 F. 2d 598 (C. C. A. 2d); *Villere* v. *Commissioner*, 133 F. 2d 905 (C. C. A. 5th); *Schroder* v. *Commissioner*, 134 F. 2d 346 (C. C. A. 5th); *Argo* v. *Commissioner*, 150 F. 2d 67 (C. C. A. 5th), certiorari denied November 5, 1945; *Supornick* v. *Commissioner*, 150 F. 2d 110 (C. C. A. 8th); *Miller* v. *Commissioner*, 150 F. 2d 823 (C. C. A. 2d); *Grant* v. *Commissioner*, 150 F. 2d 915 (C. C. A. 10th); *Bradshaw* v. *Commissioner*, 150 F. 2d 918 (C. C. A. 10th); *Estate of Sewell* v. *Commissioner* (C. C. A. 5th), decided November 9, 1945, not yet reported; *Buchanan* v. *Commissioner*, 20 B. T. A. 210; *Robertson* v. *Commissioner*, 20 B. T. A. 112; *McIntyre* v. *Commissioner*, 37 B. T. A. 812; *Lowry* v. *Commissioner*, 3 T. C. 730, pending on review by the United States Circuit Court of Appeals for the Sixth Circuit; *Hash* v. *Commissioner*, 4 T. C. 878, pending on petition for review by the United States Circuit Court of Appeals for the Fourth Circuit; *McEachern* v. *Commissioner*, 5 T. C. 23; *Munter* v. *Commissioner*, 5 T. C. 39; *Thorrez* v. *Commissioner*, 5

Family partnership arrangements predicated upon technical transfers of capital are not immune from the operation of the basic principles discussed at the outset of this brief. It is accordingly well settled that although the transfer and the partnership agreement are valid under state law, the arrangement is without federal income tax significance if in substance and practical effect it amounts primarily to an attempted reallocation of the transferor-taxpayer's business income. It should be immaterial in this connection whether the business income sought to be reallocated is derived from the taxpayer's personal services, from capital transferred by him to a "partner" and reinvested in the business, or from a combination of both sources. Since it is elementary that income from personal services is taxable to him who earns it (*Lucas* v. *Earl, supra; Helvering* v. *Eubank, supra; Burnet* v. *Leininger, supra*), the business income derived from the transferor-taxpayer's services remains taxable to him despite the partnership arrangement (*Doll* v. *Commissioner,* 149 F. 2d 239 (C. C. A. 8th), certiorari denied October 8, 1945; *Tinkoff* v. *Commissioner,* 120 F. 2d 564 (C. C. A. 7th), certiorari denied, 314 U. S. 581; *Schroder* v. *Commissioner,* 134 F.

T. C. 60; *De Korse* v. *Commissioner*, 5 T. C. 94; *Fox* v. *Commissioner*, 5 T. C. 242; *Singletary* v. *Commissioner*, 5 T. C. 365; *Greenberg* v. *Commissioner*, 5 T. C. No. 90; *Mauldin* v. *Commissioner*, 5 T. C. No. 91; cf. *Jones* v. *Page*, 102 F. 2d 144 (C. C. A. 5th), certiorari denied, 308 U. S. 562.

2d 346 (C. C. A. 5th); *Villere* v. *Commissioner*, 133 F. 2d 905 (C. C. A. 5th); *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. C. A. 2d); *Fisher* v. *Commissioner*, 29 B. T. A. 1041, affirmed *per curiam*, 74 F. 2d 1014 (C. C. A. 2d)). And since it is equally fundamental that income from property is taxable to him who commands the economic benefits of ownership (*Helvering* v. *Clifford, supra*; cf. *Harrison* v. *Schaffner, supra*), the business income attributable to capital likewise remains taxable to the transferor-taxpayer if the transfer of capital and the accompanying partnership arrangement do not serve to deprive him of the control of the capital or of substantial enjoyment of the profits produced by it (*Lorenz* v. *Commissioner*, 3 T. C. 746, affirmed *per curiam*, 148 F. 2d 527 (C. C. A. 6th), petition for rehearing denied October 15, 1945; *Earp* v. *Jones*, 131 F. 2d 292 (C. C. A. 10th), certiorari denied, 318 U. S. 764; *Mead* v. *Commissioner*, 131 F. 2d 323 (C. C. A. 5th), certiorari denied, 318 U. S. 777; *Supornick* v. *Commissioner*, 150 F. 2d 110 (C. C. A. 8th); *Miller* v. *Commissioner*, 150 F. 2d 823 (C. C. A. 2d); *Losh* v. *Commissioner*, 145 F. 2d 456 (C. C. A. 10th); *Bradshaw* v. *Commissioner*, 150 F. 2d 918 (C. C. A. 10th); *Grant* v. *Commissioner*, 150 F. 2d 915 (C. C. A. 10th); *Argo* v. *Commissioner*, 150 F. 2d 67 (C. C. A. 5th), certiorari denied November 5, 1945; *Estate of Sewell* v. *Commissioner* (C. C.

A. 5th), decided November 9, 1945, not yet reported).[4]

3. In applying the foregoing principles, the question whether a particular family partnership arrangement works such a substantial change in the transferor-taxpayer's control of the business or enjoyment of the profits as to insulate him from liability for the tax on income, normally presents an issue of ultimate fact, and has been so treated. *Doll* v. *Commissioner*, 149 F. 2d at 244, 247; *Argo* v. *Commissioner*, 150 F. 2d at 68; *Lorenz* v. *Commissioner*, *supra*; *Miller* v. *Commissioner*, 150 F. 2d at 824; *Supornick* v. *Commissioner*, 150 F. 2d at 111; *Grant* v. *Commissioner*, 150 F. 2d at 917; *Bradshaw* v.

[4] Under like reasoning we think that in an appropriate case the Commissioner might determine that, even though the wife actually made more than a nominal contribution to the partnership capital, the partnership arrangement is effective only in part or that the allocation of earnings to her exceeds that which her capital has produced for her, and to the extent that it does is a mere allocation of family income. If the arrangement for sharing the profits with the wife reflects not only her contribution but also an assignment to her of future earnings from the husband's services or capital, such an assignment is ineffective for purposes of Section 22 (a), "however skillfully devised" (*Lucas* v. *Earl*, *supra*, p. 115; *Harrison* v. *Shaffner*, *supra*, p. 582), and of course may not be effective by being commingled with another transaction which itself is effective. The Commissioner may separate the constituent elements and deal with them accordingly. Cf. *German* v. *Commissioner*, 2 T. C. 474; 483–484; *Mauldin* v. *Commissioner*, 5 T. C. No. 91, pp. 5–6; Mellott, J., concurring in *Thorrez* v. *Commissioner*, 5 T. C. 60, 72; *McEachern* v. *Commissioner*, 5 T. C. 23, 31.

Commissioner, 150 F. 2d at 920; *Estate of Sewell* v. *Commissioner, supra; Mead* v. *Commissioner,* 131 F. 2d at 324; *Waldburger* v. *Helvering,* 131 F. 2d 598. As this Court observed in the similar *Clifford* case, 309 U. S. at 336, "no one fact is normally decisive." Since it is the function of the Tax Court to weigh the evidence, find the facts, and choose between possible inferences, its decision is entitled to finality if it has applied the correct principles. *Commissioner* v. *Court Holding Co., supra; Commissioner* v. *Scottish American Co.,* 323 U. S. 119; *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231; *Wilmington Co.* v. *Helvering,* 316 U. S. 164.

While we think that some decisions of the Tax Court in the family partnership cases apparently have rested on erroneous views of the law as established by previous decisions of this Court, it is clear that those views are now held only by a minority of the Tax Court. Compare, for example, its latest decisions in *McEachern* v. *Commissioner,* 5 T. C. 23; *Munter* v. *Commissioner,* 5 T. C. 39; *Thorrez* v. *Commissioner,* 5 T. C. 60; *De Korse* v. *Commissioner,* 5 T. C. 94; *Fox* v. *Commissioner,* 5 T. C. 242; *Singletary* v. *Commissioner,* 5 T. C. 365; *Greenberg* v. *Commissioner,* 5 T. C. No. 90; and *Mauldin* v. *Commissioner,* 5 T. C. No. 91, with its somewhat earlier decisions in *Scherer* v. *Commissioner,* 3 T. C. 776, *Johnston* v. *Commissioner,* 3 T. C. 799; and *Smith* v. *Commissioner,* 3

T. C. 894. The later decisions manifest consistent adherence by a majority of the Tax Court to the correct principles of law. In the present case the Tax Court applied the correct principles of law, and its decision has abundant support in the record.

4. With a lack of any apparent purpose for the organization of a partnership other than the obvious purpose of reducing taxes on the profits of his business, the taxpayer at first considered giving his wife a half interest in the business. (R. 39, 65.) He finally decided against that plan in favor of the one outlined below.

After consulting with his accountant and attorney, the petitioner decided to make a "gift" to his wife of $50,000[5] to enable her to become a partner with him by payment of a substantial part of the purchase price of a half interest in his business. (R. 63.) The balance of the purchase price was to be represented by notes of the wife in the total amount of $55,000, payable $5,000 annually, and it was anticipated that these

[5] This sum was apparently fixed with reference to the specific exemption of $40,000 from gift tax, provided by Section 1004 (a)-1 of the Internal Revenue Code, and to the exclusion provided by Section 1003 (b) thereof. (R. 13, 46.) Although the record does not disclose how much tax was paid with respect to the gift, it is doubtful whether the tax was more than a comparatively negligible amount. Compare the situation in *Commissioner* v. *Tower*, No. 317, where the gift was valued at $57,114.60, and the gift tax amounted to $213.44. (See record, No. 317, p. 12.)

payments would be met from her agreed share of the profits of the business. (R. 15, 63.) The wife had very little to do with these arrangements or the formal agreement that followed, but did what she was told to do. (R. 28–29, 65.)

While this plan was decided upon in the latter part of 1939, the formalities of execution did not take place until nearly half the tax year involved, 1940, had elapsed. On the fourth of June, 1940, the petitioner executed a bill of sale of an undivided half interest in his business for the stated consideration of $105,253.81, and the wife executed a partnership agreement. (R. 63.) A few days later the petitioner borrowed $25,000 from a bank and gave the wife his check for $50,000, drawn against this amount, and against a further amount of $20,000 which he had withdrawn from the business in pursuance of the plan. The wife then gave him her check for $50,253.81, and the petitioner thereupon repaid the $25,000 to the bank. (R. 14, 63.) The wife also gave the petitioner eleven notes in the amount of $5,000 each, payable serially on the first day of 1941 and each following year until payment of the last of the series. (R. 56, 63.) The wife thus contributed from her own funds only $253.81, the amount of the difference between the "gift" of $50,000 and her return payment.

The notes payable over a period of eleven years did not represent any substantial contribution to the capital of the partnership. The notes were

not discounted, and it was understood that they were to be paid from the profits ascribed to the wife by the partnership agreement. (R. 15, 65.) And while the agreement provided that she should share partnership losses equally with the petitioner, her liability was of no practical significance, since in the petitioner's own view the business was worth more than $210,000, exclusive of good will; and during the tax year it had profits in excess of $80,000. The business was not a hazardous one. Its inventory was less than $40,000 at the beginning of the tax year, and slightly more than $50,000 at the end. (R. 57–58.)

In short, then, the business needed no additional capital, and by the partnership arrangement got none except the insubstantial amount of $253.81 contributed by the wife from her own funds.

Nor did the wife make any substantial additional contribution of services to the business. While it appears that she "helped out at the stores * * * whenever she was needed just as she had always done", she took no part in the management of the business, and had received no compensation for similar services before the execution of the partnership agreement. (R. 64.)

Further circumstances bear out the decision of the Tax Court that there was no partnership for purposes of Section 181, and that the petitioner had failed to establish that the Commissioner erred in determining that the entire income of the

business was includible in the petitioner's gross income under Section 22 (a).

Under the partnership agreement, the petitioner retained full control in all matters pertaining to the operation and management of the business, and his decision in these matters was to be final. (R. 49–50.) While the income of the business was derived largely from his personal services and ability as manager, no provision was made for payment of any salary to him, and it was provided that the profits of the business should be credited equally to himself and his wife. (R. 49.) Withdrawals were to be made only upon agreement of both that they would not be detrimental to the welfare or expansion of the business. (R. 50.) The agreement provided, moreover, that "under no circumstances" should either the petitioner or the wife sell or assign the interest ascribed by the partnership agreement, without the written consent of the other. (R. 50.)

The unreality of the arrangement as a business partnership is emphasized by the manner in which it was availed of during the tax year. The business was conducted in substantially the same manner under the partnership form as when the petitioner was admittedly the sole proprietor. (R. 64.) Although his personal services were largely responsible for its success, he was allowed no salary, and the wife was credited with profits of the business on an equal footing with him. (R. 64, 66.) On the other hand, she withdrew

but $59.61 of the more than $84,000 of the profits of the business during 1940, the tax year.[6] (R. 64.) During the tax year, and until 1943, the bank with which the business dealt was not authorized to accept the wife as a partner with power to draw checks; and the petitioner continued to file social security tax returns as owner of the business throughout the tax year. (R. 16–19, 70.)

It is apparent, then, that the wife was a partner in name and on paper only. For a capital contribution of little more than $200, made in the middle of the tax year, and for services which had previously been deemed of so little consequence as to merit no payment of compensation, the wife was credited with profits of the business in excess of $40,000, yet withdrew less than $60. And on the record it is inconceivable that the petitioner could have considered himself any the poorer after the making of the partnership arrangement. Cf. *Helvering* v. *Clifford,* 309 U. S. at 335–336. Plainly the Tax Court was not bound

[6] While the wife withdrew substantial amounts after the tax year involved, the withdrawals apparently were made principally to make payments on the notes executed to cover the purchase price. (R. 9.) In the absence of evidence to the contrary, it may not be assumed that any withdrawals in excess of amounts needed for that purpose were not used to satisfy the petitioner's legal or moral family obligations. Cf. *Helvering* v. *Clifford*, 309 U. S. at 335. And in any event, an arrangement for deflecting income may not be validated by events subsequent to the tax year in question. Cf. *Argo* v. *Commissioner, supra.*

as matter of law to accord tax consequences to this transparent device.

To permit the technical considerations relied on by the petitioner to prevail in this case would "exalt artifice above reality" (*Gregory* v. *Helvering*, 293 U. S. at 470), give effect to the very type of formalism which this Court has consistently held ineffective (e. g., *Helvering* v. *Clifford*, 309 U. S. at 336–337; cf. *Commissioner* v. *Smith*, *supra*), and "permit the schemes of taxpayers to supersede legislation" (*Higgins* v. *Smith*, 308 U. S. at 477). See also, *Miller* v. *Commissioner*, *supra*.[7]

5. The petitioner's argument that he retained no more control than is sometimes conferred upon a manager or agent in business transactions is like the contention made in the *Clifford* case which sought to assimilate the donor's control with that of an ordinary fiduciary. But this Court firmly rejected that contention, saying (309 U. S. 335–336):

[7] In the *Miller* case the Circuit Court of Appeals said of a family partnership arrangement predicated upon a gift of capital (150 F. 2d at 824):

> * * * the completeness with which the forms were observed is of no significance, for it is precisely what we should expect, if they were to be only forms. * * * Unless we must allow ourselves to be fobbed off by an elaborate documentary paraphernalia, because it is completely carried out, it is impossible to upset the finding. Indeed, it shows a curious trust in the efficacy of the written word, that the appeal should have gone beyond the Tax Court.

> If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property.

And the argument erroneously assumes that retention of control of principal is the only substantial attribute of ownership which might support an inference that the donor remains the substantial owner for purposes of Section 22 (a). It is plain from the opinion in the *Clifford* case (pp. 336–337) that while retention of control over *corpus* may sometimes be the "all-important factor" *per se*, "no one fact is normally decisive" and continued enjoyment of other economic benefits, direct or indirect (as was the case here), may also warrant that conclusion; it is the entire "bun-

dle of rights" retained by the donor that the trial court must consider.*

True, the agreement provided that the partnership was to last for a period of 15 years, and that upon "dissolution and liquidation * * * the assets of said partnership at the time of said dissolution or liquidation shall be divided or apportioned equally between the Partners according to their respective capital interests or investments in the partnership, as shown by the books of the partnership as of the date of dissolution." (R. 48–49). This provision appears to contemplate that the interest of the wife for purposes of liquidation might be quite different from that asserted for purposes of this case. Cf. *Grant* v. *Commissioner,* 150 F. 2d at 917. The wife's interest for purposes of this case appears to have been "more fanciful than real." *Earp* v. *Jones,* 131 F. 2d at 293. In the absence of a formal provision of this nature the arrangement might have lacked even the bare legal formal requisites; its presence, however, clearly did not preclude the Tax Court from concluding that for all practical purposes the peti-

* Since petitioner here continued to enjoy the income benefits, in addition to management control of the principal, the instant case is an even stronger one than the *Clifford* case for treating the donor as the substantial owner. In the *Clifford* case it was stipulated (p. 333) that all of the income was placed in the wife's personal checking account, that it was expended by her on herself and her children, and that the donor-husband used other funds to relieve himself of his duty to support.

tioner remained the owner of the business during the tax year. In the words of this Court in the *Clifford* case (309 U. S. 336–337):

> To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which have little or no significance in such household arrangements.

The petitioner could no more deflect for purposes of Section 22 (a) the income from property of which he retained such substantial control than he could deflect income from his personal services; the same principles require that both be included in his gross income as defined by that section. E. g., *Helvering* v. *Clifford, supra*; *Commissioner* v. *Harmon, supra.* The petitioner has put misplaced reliance on *Blair* v. *Commissioner,* 300 U. S. 5, as sustaining his contention that the incidence of the federal income tax is controlled by state concepts of title. The opinion of this Court in that case expressly recognized that transfer of title to property under state law is not determinative of federal income tax liability where the transferor retains control or other means of economic enjoyment. See 300 U. S. at 12.

The principle that a gift of income from property of which the donor retains controls equivalent to substantial ownership is ineffective for

purposes of Section 22 (a) although it may be valid and effectively pass title for purposes of state law, of course applies with undiminished force where the partnership form is employed. *Grant* v. *Commissioner, supra*; *Bradshaw* v. *Commissioner, supra*; *Argo* v. *Commissioner, supra*; *Lorenz* v. *Commissioner, supra*; *Losh* v. *Commissioner,* 145 F. 2d 456 (C. C. A. 10th); *Miller* v. *Commissioner, supra*; *Mead* v. *Commissioner, supra*; *Schroder* v. *Commissioner, supra*; *Covington* v. *Commissioner, supra.* The petitioner's arguments with respect to the validity of the partnership, and of the effect of the transaction as passing title to his wife, are therefore inapposite.

The early opinions of the lower federal courts relied upon by the petitioner are not authoritative to the extent that they may be understood to sustain his position. Compare, e. g., *Rose* v. *Commissioner,* 65 F. 2d 616 (C. C. A. 6th), and *Bardach* v. *Commissioner,* 90 F. 2d 323 (C. C. A. 6th), with the later ruling by the same court in *Lorenz* v. *Commissioner, supra*;[9] and *Edson* v.

[9] Although it is true that the Sixth Circuit Court of Appeals ruled against the Government in the *Tower* case, No. 317, that decision was by a divided court, with Judge Martin dissenting; in the *Lorenz* case, decided 11 days later, where Judge Martin was joined by two other judges, the decision was unanimously for the Government. Thus, of the five judges who have recently considered this issue in the Sixth Circuit, only two have indicated views at variance with our position herein.

Lucas, 40 F. 2d 398 (C. C. A. 8th), with the decision by the same court in *Tyson* v. *Commissioner*, 146 F. 2d 50. The partnership arrangement was in substance merely an anticipatory assignment of business income which, like any other gift of income, is unavailing for purposes of Section 22 (a).[10] *Harrison* v. *Schaffner, supra*; *Helvering* v. *Horst, supra*; *Helvering* v. *Eubank, supra*; *Burnet* v. *Leininger, supra*; *Lucas* v. *Earl, supra*. In the *Schaffner* case, this Court held (312 U. S. at 582) that a donor could not escape tax on income from the corpus of a trust by "attempting to clothe the transaction in the guise of a transfer of trust property rather than the transfer of income, where that is its obvious purpose and effect". That a gift of income is irrevocable under state law is of course inconsequential for purposes of Section 22 (a). *Lucas* v. *Earl, supra*; *Commissioner* v. *Harmon, supra*.

Finally, it can avail the petitioner nothing to contend that the partnership arrangement was made in good faith, whatever that may mean. The Tax Court apparently considered that it was not. (R. 65.) While the lack of any apparent purpose other than tax avoidance constituted a

[10] The Tax Court properly ignored the wife's contributions of the insubstantial amount of $253.81, and of relatively unimportant personal services, since the petitioner made no effort to prove that any amount should be allocated to those sources. Cf. *Welch* v. *Helvering*, 290 U. S. 111; *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590. See also, footnote 4, *supra*.

cumulative factor sustaining the Tax Court's decision, there is no warrant whatever for the view that Section 22 (a) would have to yield to the taxpayer's good faith. It is well settled that tax consequences flow from the true nature of the transaction, irrespective of its motivation. *Gregory* v. *Helvering, supra; Higgins* v. *Smith, supra; Griffiths* v. *Commissioner, supra; Helvering* v. *Clifford, supra.*

CONCLUSION

The decision below is correct and should be affirmed.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
ARNOLD RAUM,
HELEN R. CARLOSS,
JOHN F. COSTELLOE,
Special Assistants to the Attorney General.

DECEMBER 1945.

APPENDIX

Internal Revenue Code:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *. (26 U. S. C. 11.)

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 22.).

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of

the partnership, computed as provided in section 183 (b). (26 U. S. C. 182.)

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) *General rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual except as provided in subsections (b) and (c). (26 U. S. C. 183.)

SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner. (26 U. S. C. 188.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member

in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U. S. C. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

U. S. GOVERNMENT PRINTING OFFICE: 1948

FILE COPY

Office - Supreme Court, U. S.
FILED
JAN 10 1946
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 363.

A. L. LUCKMAN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

MOTION AND BRIEF OF AMICUS CURIAE.

JOSEPH B. BRENNAN,
Amicus Curiae.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 263.

A. L. LUSTHAUS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

MOTION.

The undersigned respectfully moves this Honorable Court for leave to file the annexed brief as amicus curiae.

JOSEPH B. BRENNAN,
First National Bank Building,
Atlanta, Georgia.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 263.

A. L. LUSTHAUS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF OF AMICUS CURIAE.

Behind the camouflage of confusing words and phrases, it is obvious that the Government is here seeking to establish the broad proposition that the sole proprietor of a business cannot relieve himself of tax on the entire business income by an absolute gift to his wife of an undivided interest in the business assets under circumstances where the business is continued by a partnership of husband and wife, but with the wife rendering no personal service.

The technical arguments advanced in support of the proposition are (1) that the wife cannot be a real partner

where she contributes neither capital nor services, and (2) that the control which the husband retains over the business as managing partner warrants taxing the entire income to him. These arguments are unsound, as will be demonstrated.

The real argument in support of the proposition is that it will help prevent the loss of revenue resulting from the transfer of income-producing property from husband to wife and that the taxing of the husband with income from such property would be fair in the light of the normal "control" which a husband is supposed to have, as a practical matter, over his wife's property and income. This argument has been repeatedly urged upon Congress in support of the recommendation for mandatory joint returns for husband and wife. Congress has steadfastly refused to enact any such provision, and any attempt by the courts to reach such a result, even to a limited extent, would be unwarranted judicial legislation.

The absurdity of the Government's technical argument that the wife cannot be a partner where she contributes neither capital nor services may be illustrated by the case where the sole owner of a manufacturing or mercantile business makes an outright gift of all the business assets to his niece and her husband, who continue the business as a partnership, through the management of a paid employee, with neither of the partners rendering personal services. It would be a novel and unsound legal contention to assert that there was no real partnership because neither of the two partners contributed capital or services to the enterprise. Yet there is certainly nothing in the Internal Revenue Code which would justify a distinction between a case of that kind where a partner's capital is contributed by gift from an outsider, and the case where a partner's capital is contributed by gift from her husband.

The Government is just as clearly unsound in arguing that where a husband undertakes to give his wife an interest in his business, to be conducted by a partnership of the hus-

band and wife, but with the husband acting as managing partner, the "control" which the husband thereby retains over the business warrants taxing the husband with the entire business income. Here again the source of the wife's acquisition of her interest in the business should have nothing to do with the case. Suppose the business had been conducted originally by the wife's father and her husband as equal partners, under an agreement recognizing the husband as managing partner, and the wife's father died leaving his interest in the business to her. If the business should be continued by a partnership of husband and wife upon the same terms, the Government would certainly not contend at this stage that the entire business income should be taxed to the husband because of his "control" as managing partner. The language of the Internal Revenue Code does not warrant any distinction between the two cases.

The arguments which the Government urges for taxing to the husband the whole income of a partnership business where the wife furnishes no services and her capital interest comes by gift from the husband would apply with just as much reason in the case of a gift by a husband of stock in a corporation managed by him and in which she is not employed. It could equally be said of such a business that the wife is not a real owner because she contributed neither services nor capital and the control exercised by the husband, if he retained the majority stock, would be more complete than in the case of the partnership. Yet the Government would not have the temerity to suggest the application of the principles here urged. However, neither the Government nor the courts have suggested any justification in the language of the revenue statutes for a different treatment of the partnership situation.

The loss of revenue resulting from gifts from husbands to wives and the use of family partnerships has been called to the attention of Congress on a number of occasions in connection with the recommendation for mandatory joint returns. In December, 1933, Acting Secretary Morgenthau

asked the Committee on Ways and Means of the House of Representatives to consider "whether a husband and wife living together should not be required to file a single joint return, each to pay the tax attributable to his share of the income."[1] The proposal was successively urged by Treasury representatives at hearings before the House Committee in 1933, in 1934 and in 1937; and finally a provision for mandatory joint returns was reported favorably by the House Committee in the Revenue Bill of 1941.[2] The Committee Report went into the subject in great detail, referring specifically to cases in which "such (family) partnerships have been recognized, even though the wife did not contribute either capital or services to the partnerships."[3] Opposition to the proposal was expressed by a minority of the Committee.[4] The House rejected the provision, notwithstanding the arguments of policy which were advanced in its support and which lie at the basis of the Government's contention in the present case.

The Treasury's principal spokesman for mandatory joint returns, at hearings before Congressional Committees, has recognized that there are certain social considerations that weigh against the proposal. Magill, *"Taxable Income,"* (rev. ed.) p. 330. In any event, the arguments in support of the proposal have not impressed Congress sufficiently to cause the enactment of any such provision.

Under these circumstances, the attempt by the lower courts to reach the result of combining the separate partnership income of husband and wife for the application of

---

[1] Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Sub-Committee of the Committee on Ways and Means, Relative to Methods of Preventing the Avoidance and Evasion of Internal Revenue Laws (U. S. Government Printing Office 1933) pages 14-15.

[2] See House Report No. 1040, 77th Cong. 1st Sess. pp. 11-22, 62-69.

[3] Op. cit. supra, note 2, p. 13.

[4] Op. cit. supra, note 2, p. 69.

the graduated surtax, by means of distorting well established principles of partnership law, is particularly vicious. If there is any need for compulsory joint returns, so as to tax as a part of the husband's income the wife's income from a partnership interest which he has given her or the wife's income from all other property which he has given her, that is a matter which should be left to Congress. There is not a word in the present statutes to justify the courts in singling out partnership interests for such treatment.

CONCLUSION.

It is respectfully submitted that the decision of the Circuit Court of Appeals in this case is erroneous and should be reversed.

Respectfully submitted,

JOSEPH B. BRENNAN,
First National Bank Building,
Atlanta, Georgia,
Amicus Curiae.

p. 6.

SUPREME COURT OF THE UNITED STATES.

No. 263.—October Term, 1945.

A. L. Lusthaus, Petitioner, vs. Commissioner of Internal Revenue. } On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[February 25, 1946.]

Mr. Justice Black delivered the opinion of the Court.

The question in this case is the same as in *Commissioner* v. *Tower*, No. 317, decided this day. Here, too, the Commissioner made a deficiency assessment against the husband, petitioner, for purported partnership earnings reported in his wife's return for 1940 and not reported by the petitioner. The Commissioner's action was based on a determination, made after an investigation, that for income tax purposes no partnership existed between the petitioner and his wife. The following are the controlling facts: Petitioner has operated a furniture business since 1918 and since 1933 he has conducted a retail furniture business at two stores located in Uniontown, Pennsylvania. His wife helped out at the stores whenever she was needed without receiving compensation. In 1939 the petitioner found himself confronted with the prospect of large profits and correspondingly large income taxes. This caused him concern and he called in his accountant and attorney. Together they worked out a plan for the supposed husband-wife partnership here involved. The wife had little to do with the whole transaction, and testified when asked about the details that "on the advice of counsel I did what he told me to do". In accordance with the plan the petitioner executed a bill of sale to his wife by which he purported to sell her an undivided half interest in the business for $105,253.81. At the same time the wife executed a partnership agreement under which she undertook to share profits and losses with her husband. The wife paid for her undivided half interest in the following way. Petitioner borrowed $25,000 from a bank and gave his wife a check for $50,000 drawn against the amount borrowed and further funds which he had withdrawn from the business and deposited with the bank for that purpose. The wife

then gave petitioner her check for $50,255.81 and the petitioner repaid the $25,000 to the bank. Petitioner's wife also gave him eleven notes in the amount of $5,000 each of which according to an understanding were to be paid from the profits to be ascribed to the wife under the partnership agreement.[1] Petitioner reported in a 1940 gift tax return that he had made a gift of $50,000 to his wife. Pennsylvania issued petitioner and his wife a certificate authorizing them to carry on the business as a partnership. When the partnership was formed petitioner's wife owned her home, valued at twenty-five to thirty-thousand dollars and securities worth up to twenty-five thousand dollars.

After the partnership was formed the wife continued to help out in the stores whenever she was needed just as she had always done. But petitioner retained full control of the management of the business. His wife was not permitted to draw checks on the business bank account. During the taxable year here involved the husband filed social security tax returns as owner of the business. Neither partner could sell or assign the interest ascribed by the partnership agreement without the other's written consent. Though, at the close of each year the profits of the business were credited on the books to petitioner and his wife equally, no withdrawals were to be made under the partnership agreement unless both partners agreed. The husband drew no salary. During 1940, which is the tax year here involved, the business net profits were in excess of $80,000, from which the respondent withdrew about $4,500 and his wife withdrew only $59.61. The following year they withdrew approximately $16,000 and $19,900 respectively, the wife's withdrawal being used largely to pay back some of the $5,000 notes given as part of her alleged contribution to the partnership capital. On this evidence the Tax Court found

[1] The Tax Court found as follows on this phase:

"He [the husband] would make her a 'gift' of a part of the purchase price and take her promissory notes for the balance. She could pay off the notes from her share of her profits of the business." A part of the testimony supporting this finding was given by the husband as follows:

"Q. And what were the terms of that oral agreement?

"A. Just as I stated, that she [the wife] would pay me $50,000 in cash and the balance to be paid in notes.

"Q. Payable yearly?

"A. Payable yearly in notes.

"Q. In the amount of $5,000 each for 11 years?

"A. Yes.

"Q. Where was she to get the amount to be paid off yearly?

"A. From the profits of the business."

that the wife acquired no separate interest in the partnership by turning back to her husband the $50,000 which he had given her conditioned upon her turning it back to him; and that the partnership arrangements were merely superficial, and did not result in changing the husband's economic interest in the business. It concluded that while the partnership was "clothed in the outer garment of legal respectability" its existence could not be recognized for income tax purposes. 3 T. C. 540. The Circuit Court of Appeals affirmed. 149 F. 2d 232. The petitioner challenges the Tax Court's finding that the wife was not a genuine partner on the ground that the evidence did not support it. We hold that it did.

For the reasons set out in our opinion in *Commissioner* v. *Tower*, No. 317, decided this day, the decision of the Circuit Court of Appeals is affirmed.

Affirmed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

Mr. Justice REED, dissenting.

As the Court considers, and as we do, the question in this case is the same as that in *Commissioner* v. *Tower*, decided today, and as the Court relies to support its conclusion upon the reasons set out in the *Tower* opinion, we shall state the grounds for our dissent in this case rather than the *Tower* case. We choose this certiorari for our explanation because the issue stands out more boldly in the light of the facts before and findings of the Tax Court.

A. L. Lusthaus, as an individual proprietor, had operated a furniture business in Uniontown, Pennsylvania, for a number of years. In 1939 a realization of existing and prospective federal income tax burdens caused him to cast about for a legal means of lessening the tax. Such method of tax avoidance has not heretofore been considered illegal and appropos of this rule, this Court says today in the *Tower* opinion, "We do not reject that principle." See *Gregory* v. *Helvering*, 293 U. S. 465, 469, and cases cited; *Bullen* v. *Wisconsin*, 240 U. S. 625, 630-31.

The statement in the Court's opinion adequately covers the facts. But it should not be inferred from the Court's statement

that the notes given were "according to an understanding . . . to be paid from the profits to be ascribed to the wife under the partnership agreement," that payment of the notes was so limited. The notes were unconditional promises to pay. The payment of them from profits was only a hope.

It is essential, too, we think, to note that in these partnership cases the tax doctrine of *Lucas* v. *Earl*, 281 U. S. 111, 115, as to the attribution of income fruit to a different tree from that on which it grew is inapplicable. Here, so far as the income is attributable to the property given, the gift cannot be taken as a gift of income before it was earned or payable, as in *Lucas* v. *Earl*, 281 U. S. 111; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122, where the income was held taxable to the donor. It was a gift of property which thereafter produced income which was taxable to the donee, as in *Blair* v. *Commissioner*, 300 U. S. 5; cf. *Helvering* v. *Horst*, *supra*, 119.

From first to last, the record shows a controversy as to whether the business is a valid partnership under the tax laws. The issue never has been whether Mr. Lusthaus failed to return his personal earnings for taxation. There was no effort on the part of the Commissioner to tax him upon a part or all of the partnership earnings as personal compensation which he had earned individually but assigned to the partnership for collection or which he had earned individually but caused to be paid to a fictitious partnership. While the Tax Court pointed out that the income resulted in part from petitioner's managerial ability, it also recognized that the capital contributed to the earnings. 3 T. C. at 543. The Tax Court thought that the wife acquired "no separate interest of her own by turning back to petitioner the $50,000" which had been given her conditionally and for that specific purpose. Why it thought the wife did not become an owner in the partnership business, the Tax Court does not explain. The Court's opinion does not turn upon any issue which is connected with the value of Mr. Lusthaus' services and we mention it only for the purpose of focusing attention upon what seems to us the Court's error. If the case was in the posture of a tax claim against Mr. Lusthaus based upon his failure to account for income actually earned by him but paid to his wife, an entirely different issue would be presented.

Since the questions of taxability in this case turn on the wife's bona fide ownership of a share in the partnership, we cannot say

that federal law is controlling. Even if it were, we are pointed to no federal law of partnership which precludes the wife's becoming a partner with her husband and making her contribution to capital from money or property given to her by her husband, as well as from any other source.[1]

The Court's opinion does not hold that income of husband and wife must be taxed as one. Congress has refused to do this although urged to do so.[2] It does not hold that a wife may not be a partner of her husband under some circumstances. It is said she may be "If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things . . . 26 U. S. C. §§ 181, 182." (*Tower* slip opinion, p. 7) But as we read the Court's opinion, it decides that a wife may not become a partner of her husband for federal income tax purposes, if the husband gives to her, directly or indirectly, the capital to finance her part of the partnership investment unless she also substantially participates in the management of the business or otherwise performs vital additional services. This conclusion we think is erroneous. There is no provision or principle of the Internal Revenue laws which prevents a husband from making a gift of property to his wife, even though his motive is to reduce his taxes, or which requires the income thereafter to be taxed to the husband if the gift is genuine and not pretended and he has retained no power to deprive the wife of the property or its income.

We have pointed out that the amount of earnings to be allocated to petitioner's managerial abilities is not in issue. There is no

---

[1] Of course, federal tax provisions are not subject to state law. United States v. Pelzer, 312 U. S. 399, 402 f. As rights under partnership arrangements are so essentially local, Congress by selecting the receipt of income as the taxable incident may have intended to leave the determination of its character as partnership or individual to state law. "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." Morgan v. Commissioner, 309 U. S. 78, 80; Heiner v. Mellon, 304 U. S. 271, 279. See Blair v. Commissioner, 300 U. S. 5, 9; Crooks v. Harrelson, 282 U. S. 55; Uterhart v. United States, 240 U. S. 598, 603.

In Lucas v. Earl, 281 U. S. 111, the validity of the contract to transfer sums earned was not significant to the inquiry as to who earned the compensation.

[2] Revenue Bill of 1941, H. R. 5417, as introduced, 77th Cong., 1st Sess., Sec. 111; H. Rep. No. 1040, 77th Cong., 1st Sess., p. 10; 87 Cong. Rec. 6731-32. See Mandatory Joint Returns, Joint Committee on Internal Revenue Taxation, U. S. Gov. Printing Office, 1941. It is an old problem. Statement, Secy. of Treas., Tax Avoidance, 1933, Ways & Means Committee.

question but that the gift of $50,000 was complete either in itself or joined with the subsequent transfer of a half interest in the partnership assets by payment of that $50,000 plus the additional cash and notes. On termination of the partnership, half of the assets would go to her. On her death, her interest in the partnership would go to her heirs or legatees. The value of her individual property — $45,000 to $55,000 — would increase the financial strength of the partnership as it would become subject to claims against the partnership. Uniform Partnership Act [illegible]; *Aiton* v. *Slater*, 298 Mich. 469, 47[illegible] Her husband paid his federal gift tax on the $50,000. The fact that the partnership "brought about no real change in the economic relation of the husband and his wife to the income in question" cannot affect taxability any more in the present than in any other marital situation where individual incomes exist within the intimate family circle. When a stockholder in a corporation gives stock to his wife, the family's gross income remains the same. It is only surtaxes which are reduced.

Congress taxes partnership income to the partners distributively.[3] It has defined partnership to the extent shown below.[4] The term "partnership" as used in Section 182, Internal Revenue Code, means ordinary partnerships. *Burk-Waggoner Assn.* v. *Hopkins*, 269 U. S. 110, 113. When two or more people contribute property or services to an enterprise and agree to share

---

[3] 26 U. S. C. §182. "Tax of partners. In computing the net income of each partner, he shall include, whether or not distribution is made to him —

"(a) As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months.

"(b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than 6 months.

"(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b)."

[4] 26 U. S. C. § 3797. "Definitions. (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof —

. . . . . .

"(2) Partnership and Partner. — The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."

(Penna.), Title 59, § 37, Purdon's Penna. Stat.

the proceeds, they are partners.[5] The Court says, *Tower* opinion, slip pages 4 and 5, that "When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." The suggestion seems to be that an inference of intention entirely contrary to all the primary facts may be deduced at will and without challenge by the Tax Court. People intend the consequences of their acts. When all the necessary elements of a valid partnership exist and no evidence is produced which points the other way, an intention to be partners must follow. Lindley, Partnership (10th Ed.), 44. This situation exists in this and the *Tower* case. The purpose to reduce taxes on family income certainly is not evidence of intention not to form a partnership.

The wives contributed property if the gifts of money for investment in the partnerships were valid. The Court treats the validity of the gift in the *Tower* opinion, slip p. 6, as immaterial. In this, the *Lusthaus* case, there is no question made by the Tax Court as to the validity of the gift. Since the Revenue Code recognizes the power of a taxpayer to make gifts of his property on payment of a gift tax where due, I. R. C., 1000 *et seq.*, such a transfer is valid if real and complete. There was no evidence in either the *Tower* or this case that the fact conditions for a completed gift were not satisfied or that a genuine gift was not intended, or that the husband in fact or in law retained any right or power to deprive the wife of the property given to her or the income from it. Property was transferred absolutely and beyond recall without consideration from the husband to the wife. That is a gift as effective between husband and wife as between strangers.[6] She did not hold in trust for her husband.

The husband was the managing partner but had no control otherwise over the distribution of assets on dissolution or of

---

[5] Campbell *v.* Northwest Eckington Co., 329 U. S. 561, 580; Karrick *v.* Hannaman, 168 U. S. 328, 334; Meehan *v.* Valentine, 145 U. S. 611, 618; Berthold *v.* Goldsmith, 24 How. 536, 541; Ward *v.* Thompson, 22 How. 330, 334.

Mich. Stat. Anno. (1937), Chap. 191, Title 20, § 20.6. "Sec. 6. (1) A partnership is an association of two [2] or more persons to carry on as co-owners a business for profit; . . ."

[6] Burnet *v.* Guggenheim, 288 U. S. 280, 286, Helvering *v.* N. Y. Trust Co., 292 U. S. 455, 462; Bogardus *v.* Commissioner, 302 U. S. 34, majority's and minority's definition; Smith *v.* Shaughnessy, 318 U. S. 177; Helvering *v.* American Dental Co., 318 U. S. 322, 330.

withholding her share of the earnings when distributed. Before distribution they were her earnings held subject to her right to an accounting and taxable to her under the Revenue Laws. This distinguishes the case from the short term trust of *Helvering* v. *Clifford*, 309 U. S. 331. Management of a business which involves only the risk of the capital of another is not the control to which the *Clifford* case refers.

To us the evidence shows, without any contradiction, that in consummation of the husband's gift to the wife a valid partnership was created to which the federal tax acts are applicable. There is no finding and no evidence that the transaction was pretended or a sham, or that the husband in fact or in law retained any power to deprive the wife of any part of her contribution to the capital or her share of income derived from it. Two right steps do not make a wrong one. From these facts the intention to form a partnership must be inferred. Upon this record the tax advantage to the husband resulting from his gift of income producing property is lawful because the gift was lawful and therefore effective to bestow on the wife the income thereafter derived from property which was her own.

The judgment should be reversed.

The CHIEF JUSTICE joins in this dissent.